Wiley Finance Series
Copyrighted Material

Islamic Finance

The New Regulatory Challenge

SECOND EDITION

SIMON ARCHER
RIFAAT AHMED ABDEL KARIM

WILEY

Copyrighted Material

Founded in 1807, John Wiley & Sons is the oldest independent publishing company in the United States. With offices in North America, Europe, Australia, and Asia, Wiley is globally committed to developing and marketing print and electronic products and services for our customers' professional and personal knowledge and understanding.

The Wiley Finance series contains books written specifically for finance and investment professionals as well as sophisticated individual investors and their financial advisors. Book topics range from portfolio management to e-commerce, risk management, financial engineering, valuation, and financial instrument analysis, as well as much more.

For a list of available titles, visit our Web site at www.WileyFinance.com.

Islamic Finance

The New Regulatory Challenge

Second Edition

EDITED BY
SIMON ARCHER
RIFAAT AHMED ABDEL KARIM

WILEY

Cover image: © iStockphoto/Fatih Karakis
Cover design: Leiva-Sposato

Copyright © 2013 by John Wiley & Sons Singapore Pte. Ltd.

Published by John Wiley & Sons Singapore Pte. Ltd.
1 Fusionopolis Walk, #07-01, Solaris South Tower, Singapore 138628

All rights reserved.

First edition published by John Wiley & Sons Singapore Pte. Ltd. in 2007.

No part of this publication may be reproduced, stored in a retrieval system, or transmitted in any form or by any means, electronic, mechanical, photocopying, recording, scanning, or otherwise, except as expressly permitted by law, without either the prior written permission of the Publisher, or authorization through payment of the appropriate photocopy fee to the Copyright Clearance Center. Requests for permission should be addressed to the Publisher, John Wiley & Sons Singapore Pte. Ltd., 1 Fusionopolis Walk, #07–01, Solaris South Tower, Singapore 138628, tel: 65–6643–8000, fax: 65–6643–8008, e-mail: enquiry@wiley.com.

Limit of Liability/Disclaimer of Warranty: While the publisher and author have used their best efforts in preparing this book, they make no representations or warranties with respect to the accuracy or completeness of the contents of this book and specifically disclaim any implied warranties of merchantability or fitness for a particular purpose. No warranty may be created or extended by sales representatives or written sales materials. The advice and strategies contained herein may not be suitable for your situation. You should consult with a professional where appropriate. Neither the publisher nor the author shall be liable for any damages arising herefrom.

Other Wiley Editorial Offices
John Wiley & Sons, 111 River Street, Hoboken, NJ 07030, USA
John Wiley & Sons, The Atrium, Southern Gate, Chichester, West Sussex, P019 8SQ, United Kingdom
John Wiley & Sons (Canada) Ltd., 5353 Dundas Street West, Suite 400, Toronto, Ontario, M9B 6HB, Canada
John Wiley & Sons Australia Ltd., 42 McDougall Street, Milton, Queensland 4064, Australia
Wiley-VCH, Boschstrasse 12, D-69469 Weinheim, Germany

ISBN 978–1–118–24704–4 (Cloth)
ISBN 978–1–118–24706–8 (ePDF)
ISBN 978–1–118–24707–5 (Mobi)
ISBN 978–1–118–24708–2 (ePub)

Typeset in 10/12 pt. Sabon-Roman by MPS Limited, Chennai, India.
Printed in Singapore by Ho Printing, Pte. Ltd.

10 9 8 7 6 5 4 3 2 1

To our beloved wives Eveline and Iglal

Contents

About the Editors xv

About the Contributors xvii

Foreword xxvii

Preface xxix

Acknowledgments xxxi

PART ONE

The Nature of Risks in Islamic Banking 1

CHAPTER 1

Supervision of Islamic Banks: The Regulatory Challenge—Basel II and Basel III 3

Simon Archer and Rifaat Ahmed Abdel Karim

1. Introduction 3
2. The Structure of Basel II and Basel III: Supervisory Implications 4
3. The Islamic Financial Services Board 5
4. Contents of This Book 6

Notes 11

References 11

CHAPTER 2

Banking and the Risk Environment 13

Brandon Davies

1. The Global Risk Environment 13
2. The Regulatory Environment 15
3. The Implementation Environment (Setting Up a Risk Management Framework in a Bank) 29

Islamic Finance: The New Regulatory Challenge.
Edited by Simon Archer and Rifaat Ahmed Abdel Karim
Copyright © 2013 by John Wiley & Sons Singapore Pte. Ltd.
ISBN: 978-1-118-62897-3

4. The Future Risk Environment 38
5. Islamic Banks and the Risk and Regulation Environment 42

CHAPTER 3
Risk Characteristics of Islamic Products: Implications for Risk Measurement and Supervision 49
Venkataraman Sundararajan
1. Introduction 49
2. Background 52
3. Types of Risks in Islamic Finance and Their Measurement 54
4. Overall Risk of an Islamic Bank and Approaches to Risk Mitigation 67
5. Summary and Policy Conclusions 69
Notes 71
References 73

CHAPTER 4
Risk in a Turbulent World: Insights from Islamic Finance 77
Sami Al-Suwailem
1. Introduction 77
2. Functions of Risk 78
3. Dealing with Risk 79
4. The Fundamental Law of Risk 80
5. Islamic Finance 84
6. Functions of Risk in Islamic Finance 85
7. Risk Exchange in Islamic Finance 87
8. Regulatory Implications 88
9. Conclusion 92
Notes 92
References 92

CHAPTER 5
Capital Structure and Risk in Islamic Financial Services 95
Simon Archer and Rifaat Ahmed Abdel Karim
1. Introduction 95
2. Risk and Capital Structure in Islamic Banks 96
3. Risk and Capital Structure in *Takaful* (Islamic Insurance) Undertakings 102
4. Concluding Remarks 105
References 105

CHAPTER 6
Inherent Risk: Credit and Market Risks **107**
John Lee Hin Hock
1. Introduction 107
2. Distinctive Risks 107
3. Inherent Risks in *Shari'ah*-Compliant Products and Services 109
4. Conclusion 112
Appendix 112
Notes 131

CHAPTER 7
Operational Risk Exposures of Islamic Banks **133**
Simon Archer and Abdullah Haron
1. Introduction 133
2. Basel III Requirements and Their Implications for Operational Risk Management 134
3. Operational Risk: The Basel Methodology 136
4. Operational Risk in Islamic Banks 137
5. Unique Operational Risks of Islamic Financing/Investment Modes 141
6. *Qard* 148
7. Concluding Remarks 151
Notes 152

CHAPTER 8
Information Technology Risks in Islamic Banks **153**
Samir Safa
1. Introduction 153
2. Important Understandings and Facts 155
3. ITS Operational Risk—Business, Documentation, and Legal Issues 157
4. Technical and Functional Clarification for the Imposed Risks 159
5. Concluding Remarks 160
Note 161

CHAPTER 9
Law and Islamic Finance: An Interactive Analysis **163**
Yusuf Talal DeLorenzo and Michael J. T. McMillen
1. Introduction and Overview 163
2. Islamic Jurisprudence in Modern Times 167
3. Enforceability of the *Shari'ah* 179

4. Enforceability of the *Shari'ah*: Case Law and Transactional Practice 189
5. Transactional Practice: Legal Opinions 195
6. *Sukuk*: Capital Markets and Secondary Markets 198
7. Summary and Conclusion 207
Appendix 209
Notes 216

CHAPTER 10
Legal Risk Exposure in Islamic Finance **225**
Andrew White and Chen Mee King
1. Introduction 225
2. Defining Legal Risk 226
3. Greater Risk from Uncertain and Undeveloped Law and Regulation 227
4. Greater Risk from Poor Documentation 228
5. Greater Risk from Unpredictable Dispute Resolution Processes 229
6. Concluding Remarks 232
Notes 233

CHAPTER 11
***Shari'ah*–Non-compliance Risk** **237**
Mohamad Akram Laldin
1. Introduction 237
2. Risk from an Islamic Perspective 238
3. The Concept of *Shari'ah* Compliance 240
4. *Shari'ah*–Non-compliance Risk and Its Impact 245
5. Dealing with *Shari'ah*–Non-compliance Risk 246
6. Measuring *Shari'ah*–Non-compliance Risk 249
7. *Fiqh al-Muwazanah* 251
8. Rectification of a *Shari'ah*–Non-compliant Contract 254
9. Mitigation of *Shari'ah*–Non-compliance Risk 256
10. Conclusion 256
Notes 257

CHAPTER 12
Supervisory Implications for Islamic Finance: Post-Crisis Environment **261**
Peter Casey
1. Regulation and Supervision 261
2. Supervisors and *Shari'ah* 261
3. Lessons of the Crisis and Regulatory Responses 264

4. The Issues for Supervisors 267
Notes 272

PART TWO

Capital Adequacy 273

CHAPTER 13
Risk and the Need for Capital 275
John Board and Hatim El-Tahir
1. Introduction 275
2. The Evolution of International Capital Standards 277
3. The Risk-Based Financial Regulation Approach 278
4. Globalisation of Financial Regulation? 281
5. The Short-Lived Rise of Contingent Capital Instruments 282
6. Conclusion 283
Notes 284

CHAPTER 14
Measuring Risk for Capital Adequacy: The Issue of Profit-Sharing Investment Accounts 285
Simon Archer and Rifaat Ahmed Abdel Karim
1. Introduction 285
2. Why Capital Adequacy? 285
3. Application to Islamic Banks 289
4. Pillar 2 of the Revised Framework and Risk Management 294
5. Concluding Remarks 296
Note 297
References 298

CHAPTER 15
Measuring Operational Risk 299
Sandeep Srivastava and Anand Balasubramanian
1. Introduction 299
2. Operational Risk in the Context of Islamic Banks 300
3. Operational Risk Capital under Basel II 301
4. Operational Risk Capital under the IFSB Standard 309
5. Industry Practice and Implementation Issues for Operational Risk Measurement 310
Appendix 315
Notes 323

CHAPTER 16

Liquidity Risk **325**

Richard Thomas

1. Introduction 325
2. The Regulatory Response to Liquidity Risk 325
3. Asset Liquidity 326
4. Trade Finance Assets as Liquidity 327
5. Government Bonds and Liquidity 328
6. Asset-Based Financings and Liquidity 328
7. The International Islamic Liquidity Management Corporation (IILM) 329
8. Liabilities (Deposits) as Liquidity 331
9. Accounting for Liquidity and Fair Value 333
10. Islamic Banks and the Basel III Liquidity Measures 334
11. Conclusion 335

Notes 336

PART THREE

Securitisation and Capital Markets **337**

CHAPTER 17

Securitisation in Islamic Finance **339**

Baljeet Kaur Grewal

1. Preface: An Overview of the *Sukuk* Market 339
2. Securitisation and *Sukuk*: Some General Remarks 342
3. Market for Securitisation in Islamic Finance 346
4. Securitisation Structures 349
5. Regulatory Framework 357
6. Securitisation: A Growth Driver for Islamic Finance 361

CHAPTER 18

The Role of Capital Markets in Providing *Shari'ah*-Compliant Liquidity **365**

Prasanna Seshachellam

1. Liquidity and Its Importance to the Islamic Financial System 365
2. Traditional Role of Capital Markets in Providing Liquidity to Financial Systems 367
3. Capital Markets—Structure and Analysis 368
4. Role of Islamic Capital Markets in Providing Liquidity 370
5. Enhancements to the Critical Dimensions of ICM to Improve Its Ability to Provide Liquidity 374
6. Products 374
7. Players 378

8. Infrastructure 379
9. Market Segments 381
10. Current Trends and Work in Progress 383

CHAPTER 19
Regulating the Islamic Capital Market 387
Nik Ramlah Mahmood
1. Introduction 387
2. The Applicability of Universal Principles of Securities Regulation 388
3. Approaches to Regulating ICM 389
4. The *Shari'ah* Governance Framework 391
5. Conclusion 395
Notes 395
References 397

PART FOUR
Corporate Governance and Human Resources 399

CHAPTER 20
Corporate Governance and Supervision: From Basel II to Basel III 401
Carol Padgett
1. Introduction: Corporate Governance and the Special Case of Banks 401
2. Regulation and the Corporate Governance of Listed Companies 402
3. Basel Pillar 2 and Corporate Governance in Banks 404
4. Conclusion 413
Notes 414

CHAPTER 21
Specific Corporate Governance Issues in Islamic Banks 417
Simon Archer and Rifaat Ahmed Abdel Karim
1. Introduction 417
2. Salient Characteristics of Islamic Banks 419
3. Corporate Governance Issues in Islamic Banks 425
4. Exercising Effective Market Discipline on Islamic Banks 434
5. Regulation of Islamic Banks 440
6. Concluding Remarks 441
Notes 443
References 446

CHAPTER 22
Transparency and Market Discipline: Post–Basel Pillar 3 **451**
Daud Abdullah (David Vicary)
1. Introduction 451
2. Compliance with Pillar 3 453
3. Transparency and Market Discipline: Specificities of Islamic Finance 457
4. Concluding Remarks 469
Notes 471

CHAPTER 23
Human Resource Management of Islamic Banks: Responses to Conceptual and Technical Challenges **473**
Volker Nienhaus
1. Introduction 473
2. Recruitment, Retention, and Qualification of Personnel 474
3. Support Infrastructure for Islamic Financial Institutions 480
4. *Shari'ah*-Compliance Issues 486

PART FIVE
Conclusion **493**

CHAPTER 24
Concluding Remarks **495**
Simon Archer and Rifaat Ahmed Abdel Karim
1. Introduction 495
2. The Challenge to Financial Sector Industry Regulators and Supervisors 496
3. The Challenge to the Islamic Financial Services Industry Sector 497
4. The Challenge to Governments and Legislative Authorities 499
5. Conclusions 500
Notes 501

Index **503**

About the Editors

Simon Archer is Visiting Professor at the ICMA Centre, Henley Business School, University of Reading, United Kingdom, with particular responsibility for Islamic finance, and Adjunct Professor at the International Centre for Education in Islamic Finance (INCEIF), Kuala Lumpur, Malaysia. Previously, he was Professor of Financial Management at the University of Surrey, after being Midland Bank Professor of Financial Sector Accounting at the University of Wales, Bangor. After studies in Philosophy, Politics, and Economics at Oxford University, he qualified as a chartered accountant with Arthur Andersen in London and then moved to Price Waterhouse in Paris, where he became Partner in Charge of Management Consultancy Services. Since beginning an academic career, Professor Archer has undertaken numerous consultancy assignments, including acting as consultant to the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and the Islamic Financial Services Board (IFSB). He has been a visiting professor at a number of universities and business schools, including IIUM in Malaysia, Bordeaux, Metz, and Paris-Dauphine; HEC and EAP-ESCP in France; Copenhagen Business School in Denmark and Frankfurt, and Koblenz in Germany. Professor Archer is the author and co-editor of a considerable number of works and academic papers on international accounting and on issues in Islamic finance, including *Islamic Finance: Innovation and Growth* (Euromoney Publications, 2002) with Rifaat Ahmed Abdel Karim; *Islamic Finance: The Regulatory Challenge, 1st edition* (John Wiley & Sons Singapore, 2007) with Rifaat Ahmed Abdel Karim; and *Takaful Islamic Insurance: Concepts and Regulatory Issues* (John Wiley & Sons Singapore, 2009) with Rifaat Ahmed Abdel Karim and Volker Nienhaus. In 2010, Professor Archer received an award from the Central Bank of Bahrain and Kuwait Finance House, Bahrain, for his "outstanding contribution to the Islamic Financial Services Industry."

Rifaat Ahmed Abdel Karim is one of the world's foremost and renowned leaders and authority in the Islamic financial services industry (IFSI) both at the professional and academic levels. He has played a pioneering role in the development of Islamic finance, while his leadership in the drafting of

Islamic Finance: The New Regulatory Challenge.
Edited by Simon Archer and Rifaat Ahmed Abdel Karim
Copyright © 2013 by John Wiley & Sons Singapore Pte. Ltd.
ISBN: 978-1-118-62897-3

accounting, auditing, governance, *Shari'ah*, and regulatory standards has been instrumental in establishing the position of the IFSI in the mainstream of global financial services.

In addition to the international recognition of his academic publications, which are mainly in tier one international journals in the field of Islamic finance, Rifaat also earned international respect for the two organisations he has played an instrumental role in creating, and for which he served as (their inaugural) Secretary-General—the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and the Islamic Financial Services Board (IFSB).

Professor Karim's contribution to the IFSI has been recognised by the many prestigious international awards that have been bestowed upon him during his career, which spans 30 years dedicated to high achievement in professional activities, as well as in research and academic work. These include, among others, the (inaugural) 2004 Euromoney Outstanding Contribution in the Development of Islamic Finance, and the 2010 Islamic Development Bank Prize in Islamic Banking and Finance. In 2010, the King of Malaysia awarded Professor Karim the Royal Malaysian Honorary Award of Darjah Kebesaran Panglima Jasa Negara (P.J.N.), which carries the title "Datuk."

Professor Karim is currently the Chief Executive Officer of the International Islamic Liquidity Management Corporation (IILM). Professor Karim has been Visiting Professor at the ICMA Centre, Henley Business School, University of Reading, United Kingdom, since 2008, and Adjunct Research Professor at the International Centre for Education in Islamic Finance (INCEIF), Kuala Lumpur, Malaysia, since 2011. He served on the advisory council of the Basel Committee for Banking Supervision, International Accounting Standards Board, and International Auditing and Assurance Standards Board.

Professor Karim is the co-author/co-editor of *Business and Accounting Ethics in Islam* (Mansell Publishing Co., 1991) with Trevor Gambling; *Islamic Finance: Innovation and Growth* (Euromoney Publications, 2002) with Simon Archer; *Islamic Finance: The Regulatory Challenge* (1st edition) (John Wiley Asia, 2007) with Simon Archer; and *Takaful Islamic Insurance: Concepts and Regulatory Issues* (John Wiley & Sons Singapore, 2009) with Simon Archer and Volker Nienhaus.

About the Contributors

Daud Abdullah (David Vicary) is the President and Chief Executive Officer of INCEIF, The Global University of Islamic Finance. He has been in the finance and consulting industry for more than 38 years, with significant experience in Asia, Europe, Latin America, and the Middle East. Since 2002, he has focused exclusively on Islamic finance where he has contributed to a number of books on the subject and has co-authored a book on Islamic finance entitled *Islamic Finance: Why it Makes Sense*. He is also a frequent speaker and commentator on matters relating to Islamic finance. He is a Chartered Islamic Finance Professional (CIFP), a Distinguished Fellow of the Islamic Banking and Finance Institute of Malaysia (IBFIM) and a former Board member (2003–2007) of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). Prior to INCEIF, he was the Global Islamic Finance Leader with Deloitte. He was also previously acting CEO of Asian Finance Bank, an Islamic bank based in Malaysia, and Managing Director of Hong Leong Islamic Bank.

Anand Balasubramanian is currently a Director in Ernst & Young's Financial Services Risk Management (FSRM) practice in Dubai. He has more than 12 years' experience in the area of risk and financial consulting across the Middle East, South East Asia, and the United States. He has executed several engagements in the area of risk quantification and model validation for credit risk, market risk, and operational risk.

He has prior experience with Oracle Financial Services Consulting, GE, and ICRA. Anand holds an MBA in Finance from the Indian Institute of Management, Calcutta, India and is certified FRM from Global Association of Risk Professionals (GARP).

John Board has been Dean of the Henley Business School at the University of Reading since October 2010. Before that he was Director of the ICMA Centre at the University of Reading, which he joined after being on the faculty at the London School of Economics.

His recent research has focused on the organisation and regulation of financial markets and the development of Islamic financial markets. Some of this work has been based on large scale analyses of trading data, while

Islamic Finance: The New Regulatory Challenge.
Edited by Simon Archer and Rifaat Ahmed Abdel Karim
Copyright © 2013 by John Wiley & Sons Singapore Pte. Ltd.
ISBN: 978-1-118-62897-3

other parts have considered more general issues of the effects of market fragmentation as well as the various scandals and crises in financial markets. As a result of this work, he has been widely published in books and academic and professional journals, as well as radio and television. He has acted as consultant to many U.K. and overseas markets, regulatory organisations, and trade bodies. These include the House of Commons, the Financial Services Authority, the City of London Corporation, and the European Commission. He also has an interest in the development of Islamic finance, on which he has recently acted as consultant on a major project on Islamic market developments around the world.

He has successfully supervised some 30 PhD students and acted as examiner for many more. His teaching work has taken place in some 20 countries, including: the United Kingdom, China, India, France, Japan, Korea, Saudi Arabia, Egypt, Spain, Argentina, Serbia, Montenegro, Russia, Thailand, Qatar, Sharjah, Abu Dhabi, Egypt, Libya, Kenya, South Africa, and others.

Peter Casey recently retired as Senior Director, Policy and Strategy, and Head of Islamic Finance in the Dubai Financial Services Authority (DFSA).

Peter has been involved in standards development in Islamic finance through membership of the IFSB Technical Committee and several IFSB Working Groups, including those on Special Issues in Capital Adequacy, Governance of Takaful Operations, and Solvency Requirements for Takaful Operators. He participated in the joint IFSB-IAIS working group on *takaful*, and in the IOSCO working group which analysed the application of IOSCO's Objectives and Principles of Securities Regulation to Islamic products. He has also been a member of the Islamic Finance Working Group of the Asian-Oceanian Standard-Setters Group. He has written two book chapters and numerous articles on Islamic finance topics.

Before joining the DFSA in 2002, Peter was Head of the Non-Life Insurance Department of the UK Financial Services Authority. Before that, he held senior regulatory posts in the Treasury, the Department of Trade and Industry and the Office of Fair Trading. He has wide experience of UK Government, having also served in the Cabinet Office and Science Research Council, and having worked in areas ranging from export promotion to the creation of computer misuse legislation.

He was educated at Cambridge University.

Brandon Davies is Non-Executive Chairman of Premier European Capital Limited, a private equity company; he is also the CEO of dRisk.biz, a company he founded, and Senior Independent Non-Executive Director (SINED) of Gatehouse Bank plc. (an Islamic Bank in London), where he

has helped to establish the "Gatehouse Thought Leadership Programme." He has worked with institutions, most notably in Malaysia, London, and Kuwait to build on this role.

Brandon holds a degree in economics from University College London. He is a member of the Financial Markets Group at the London School of Economics (LSE), lectures extensively on subjects in banking and risk management, and has written numerous papers and articles on these subjects for organisations such as the ACCA, Cass Business School, Central Banking, the LSE, Lombard Street Research, and the *Financial Times*.

Until December 2009, Brandon was Managing Director of the Global Association of Risk Professionals Risk Academy. In that capacity Brandon produced five books on Basel II and risk management, governance, supervision, and enterprise risk management. These books form the basis of certification programs in both banks and central banks in China and Indonesia.

Brandon has over 40 years of work experience in the banking sector; his positions included Head of Retail Market Risk and Treasurer of the retail businesses of Barclays Bank, and he was also a member of the bank's executive committee. Prior to this appointment he was Managing Director of Financial Engineering at BZW and later of Structured Products at BZW and Barclays Capital. Brandon retired from Barclays in March 2004 after 32 years with the bank.

Yusuf Talal DeLorenzo of Malfa Inc. (www.malfainc.com) is a scholar of Islamic transactional law whose 30-year career has been noted in the *Financial Times*, the *New York Times, Fortune*, the *Wall Street Journal*, the *Middle East Banker*, and others. Based in Florida, he serves as a *Shari'ah* advisor to international financial entities, including index providers, institutional investors, mutual funds, hedge funds, real estate funds, private equity funds, home finance providers, and investment banks. Shaykh Yusuf is the author of the three-volume *Compendium of Legal Opinions on the Operations of Islamic Banks*, the first English/Arabic reference on the *fatawa* issued by *Shari'ah* boards. In addition, he wrote the introduction to *Islamic Bonds*, the 2003 book that introduced *sukuk* and transformed the world's Islamic capital markets. His work has appeared in journals and newsletters and as chapters in books, including *Islamic Asset Management* (Euromoney Books, 2004), *Islamic Retail Finance* (Euromoney Books, 2005), and *Islamic Finance: Innovation & Growth* (Euromoney Books, 2002). His entries on the terminology of Islamic finance appear in *The Oxford Dictionary of Islam*.

Baljeet Kaur Grewal is the Managing Director and Vice Chairman at KFH Research Limited (KFHR), the investment research subsidiary of Kuwait Finance House. In her capacity, Baljeet heads the Global Economic and

Investment Research and Advisory teams at KFHR, the first Islamic bank worldwide to have a notable research presence in Islamic finance.

Prior to this, Baljeet was the head of Investment Banking Research at Maybank Group, Malaysia. Prior to that, she was attached with ABN AMRO Bank and Deutsche Bank, London, with experience ranging from credit structuring, loan syndication, and economic and capital market research. She has broad experience in investment banking, having participated in notable Islamic fund raising transactions in Asia and the Middle East; as well as in strategic planning and execution of investment banking organisational change. To date, she has undertaken research in Islamic finance with a principle focus on debt capital markets and *sukuk* in emerging markets. She has written and published numerous articles and papers on developing economies and debt markets, Islamic debt structures, and South East Asian economies; and has addressed numerous international Islamic conferences and forums. Since its inception, KFH Research Limited has been awarded nine international awards of research excellence, and is widely regarded as the best Islamic finance research house globally.

Baljeet has a First Class Honours degree in international economics from the University of Hertfordshire and has undertaken extensive research in development studies with the London School of Economics.

She is also the award recipient of the prestigious Sheikh Rashid al-Makhtoum award for Regional Contribution to Islamic Finance in Asia 2006, as well as accolades honouring women in Islamic finance.

Abdullah Haron is Assistant Secretary-General of the Islamic Financial Services Board. Previously, he was a Project Manager; his main area of work was the preparation of guidance on risk management and the supervisory review process. He has also participated in task forces on *takaful* regulation and supervision, as well as a compilation guide on prudential databases of Islamic financial services institutions. His prior experience includes the development of a risk management and measurement framework, and insurance prudential regulation and supervision. Abdullah received a BSLAS in actuarial science from the University of Illinois and an MBA from Ohio University.

Chen Mee King is Senior Vice-President, General Counsel, and Head of Legal and Shari'ah Group of The Islamic Bank of Asia Limited, the first full-fledged Islamic bank in Singapore. She is also an Adjunct Associate Professor of Law in Singapore Management University's Masters (LLM) in Islamic Law and Finance programme. During nearly 25 years of law practice, Mrs. Chen has engaged in private practice as well as acting as in-house counsel for an Asian commercial bank, two European commercial banks, and an Asian multinational investment group, before joining The Islamic Bank of Asia Limited.

Mrs. Chen's responsibilities in The Islamic Bank of Asia involve the oversight of legal matters arising in connection with the Bank's activities in South East Asia as well as its representative office in Bahrain.

Dr. Mohamad Akram Laldin is currently the Executive Director of International Shari'ah Research Academy for Islamic Finance (ISRA). Prior to joining ISRA he was an Assistant Professor at the Kulliyah of Islamic Revealed Knowledge and Human Sciences, International Islamic University, Malaysia (IIUM). In the period of 2002–2004, he was a Visiting Assistant Professor at the University of Sharjah, Sharjah, United Arab Emirates. At present, he is a member of the Bank Negara Malaysia Shari'ah Advisory Council, member of the Accounting and Auditing Organization of Islamic Financial Institution (AAOIFI) Shari'ah Board, member of the Law Harmonisation Committee Bank Negara Malaysia, member of Shari'ah Board of Employees Provident Fund Malaysia (EPF), member of Maldives Monetary Authority Shari'ah Board, member of Yassar Limited (Dubai) Shari'ah Advisory Board, member of Nigerian Central Bank Council of Experts, Chairman of the Islamic Advisory Board of HSBC Insurance Singapore, Shari'ah Advisor to ZI Syariah Advisory Malaysia, member of Shari'ah Advisory Council International Islamic Financial Market (IIFM), Bahrain, member of Thomson Reuters Islamic Benchmark (IIBR) Shari'ah Committee, member of Shari'ah Advisor of Dar Al Takaful (Dubai), and of other boards locally and internationally.

In addition, he is also the Member of the Board of Studies of the Institute of Islamic Banking and Finance, International Islamic University Malaysia, and member of the Board of Trustees of the Islamic Research Training Institute under Islamic Development Bank, Jeddah. Dr. Akram holds a BA Honours degree in Islamic Jurisprudence and Legislation from the University of Jordan, Amman, Jordan and a PhD in Principles of Islamic Jurisprudence (Usul al-Fiqh) from the University of Edinburgh, Scotland, United Kingdom. He has presented many papers related to Islamic banking and finance and other *fiqh* topics at the national and international levels and has conducted many training sessions particularly on Islamic banking and finance for different sectors since 1999. He is a registered *Shari'ah* Advisor for Islamic Securities with the Securities Commission of Malaysia, and has acted as *Shari'ah* advisor in several *sukuk* issuances. In addition he is a prolific author of academic works, specifically in the areas of Islamic Banking and Finance. He is the recipient of the Zaki Badawi Award 2010 for Excellence in Shari'ah Advisory and Research.

Dr. John Lee Hin Hock is the Group Chief Risk Officer (GCRO) of Maybank Group, the largest banking group in Malaysia. As GCRO, he oversees

the Group Credit and Risk Management function of the Group, which includes commercial banking, investment banking, and insurance business across South East Asian markets. The Group Credit and Risk Management has oversights on matters relating to credit management, assets and liabilities management, liquidity management, market risk management, and operational risk management. As GCRO, he sits on the Executive Committee and on various other management committees in the Group.

Dr. John Lee was a member of the Liquidity Risk Management Working Group and the Risk Management Working Group of the Islamic Financial Services Board (IFSB), an international standard-setting body set up to ensure the stability of the Islamic financial services industry.

Prior to Maybank, Dr. John Lee was a Partner in KPMG, where he was KPMG Global Lead for Islamic Finance, Asia-Pacific Region Head of Financial Risk Management, and Malaysia Head for Financial Services. His consulting experience includes strategic consulting, banking strategies, capital markets, risk management, and performance management, where he completed numerous projects around the Asia-Pacific region.

Before joining KPMG, John was the General Manager of the Kuala Lumpur Options & Financial Futures Exchange (KLOFFE; now known as Malaysian Derivatives Exchange), where he was responsible for the overall operations of the exchange. Prior to KLOFFE, John worked for a Malaysian merchant bank, Amanah Merchant Bank Berhad, now known as Alliance Merchant Bank Berhad, in their corporate finance department.

John Lee has a PhD in financial economics and a bachelor of economics from Monash University. He is also a Fellow Certified Practicing Accountant of CPA Australia and a member of the American Finance Association, Econometrics Society, and the Society of Financial Studies.

Dato Dr. Nik Ramlah Mahmood was appointed Deputy Chief Executive of Securities Commission (SC) Malaysia on 1 April 2012. Prior to that, she was Managing Director and Executive Director of the SC's Enforcement Division. Nik Ramlah has served the SC for more than 19 years and has worked in areas ranging from legal and regulatory reform, product and market development, Islamic capital markets, investor education, and enforcement.

Nik Ramlah sits on the board of the Securities Industry Development Corporation (SIDC), the training and education arm of SC, and is a member of the Professional Development Panel of the International Centre for Education in Islamic Finance (INCEIF), the global University of Islamic Finance and is an EXCO member of the Asian Institute of Finance (AIF).

Nik Ramlah holds a First Class Honours degree in Law from University Malaya and an LLM and PhD from the University of London. For her PhD, she was a recipient of a scholarship from the Association of Commonwealth Universities.

Prior to joining the SC in 1993, Nik Ramlah was an Associate Professor in the Faculty of Law, University Malaya.

Michael J. T. McMillen is a Partner in the international law firm of Curtis, Mallet-Prevost, Colt & Mosle LLP. He also teaches Islamic finance at the Law School and the Wharton School of Business of the University of Pennsylvania. Michael's practice focuses on Islamic finance, project finance, other structured finance, international real estate finance, and private equity. He has worked in the Islamic finance field since 1996 and has received numerous awards for his Islamic finance work, particularly for devising innovative *Shari'ah*-compliant structures and products. He has worked in the project and structured finance field since 1983. He was the founding chairman of the Islamic Finance Section of the American Bar Association. Michael received his BBA from the University of Wisconsin in 1972, his JD in 1976 from the University of Wisconsin School of Law, and his MD in 1983 from the Albert Einstein College of Medicine.

Volker Nienhaus was Professor of Economics at the German universities of Trier (1989) and Bochum (1990) before he became President of the University of Marburg (2004). His fields of academic specialisation were economics of the European Union, international and development economics, and political economy. He has made numerous contributions to Islamic economics, banking, and finance since the 1980s. In 2006, he was appointed a member of the Governing Council of the International Centre for Education in Islamic Finance (INCEIF), Kuala Lumpur.

Carol Padgett is a senior lecturer in finance at the ICMA Centre, Henley Business School. She has extensive experience of teaching corporate finance and governance to both academic and professional audiences and has written a textbook on corporate governance. She is Director of Studies of the MSc in Corporate Finance at the University of Reading. Her research interests include governance in financial and nonfinancial institutions and the impact of governance on the performance of acquisitions.

Samir Safa has more than 30 years of international experience in information technology and banking. He has managed large-scale transformation information technology projects, as well as building and implementing multidiscipline financial information solutions successfully across North America, EMEA, and Asia.

Since 1992, Samir has been serving the needs and requirements of the Islamic banking and finance industry in their various formations; i.e., start-ups, conversion of conventional banks to Islamic banks, and setting up Islamic finance units or windows.

Prasanna Seshachellam has over 19 years of experience in the financial services industry sector, which includes over nine years of experience in the regulatory domain. Before entering the regulatory world, he worked in many segments of the financial services industry, including investment banking, equity research, asset management, corporate credit, credit rating, risk management, fund administration, and trade operations for ETFs. Prasanna has worked with Barclays Global Investors Canada Limited and with ICRA Limited, the second largest rating agency in India and an affiliate of Moody's Investors Service.

In his current role at the Dubai Financial Services Authority (DFSA), Prasanna Seshachellam leads the team responsible for the prudential supervision of a number of authorised firms, with primary focus on firms operating in the banking and insurance sectors. Prior to his current role at the DFSA, Prasanna was with the Office of Superintendent of Financial Institutions (OSFI) Canada as a Senior Supervisor overseeing a portfolio of banks and other lending institutions.

Prasanna has been a key contributor to various initiatives of the DFSA in the regulation of Islamic finance. Prasanna has represented the DFSA in many working groups of the Islamic Financial Services Board. Prasanna also plays a leading role in many of the critical projects aimed to enhance the supervision framework of the DFSA.

Prasanna has a bachelor of technology degree from Anna University, India, and a masters in management from Indian Institute of Management, Bangalore. Prasanna is a CFA charter holder and also holds the FRM designation awarded by the Global Association of Risk Professionals, New York.

Dr. Sandeep Srivastava is currently a Senior Director in Ernst & Young's Financial Services Risk Management (FSRM) practice in Dubai. He has more than 15 years of experience spanning all areas of risk management and has led several projects for investment banks, commercial banks and insurance companies. He has prior experience with KPMG in the Middle East, South Asia, and Europe. He holds a PhD in finance from Indian Institute of Technology (IIT), Delhi, India, and has completed his masters and MPhil. in finance from Delhi School of Economics, Delhi, India.

He also has taught at a reputable business school in India and has authored a book titled *Volatility Forecasting and Derivative Trading in India* published by Macmillan.

Venkataraman Sundararajan (who died suddenly in 2010) was an internationally recognised financial economist with over 30 years' experience in the International Monetary Fund (IMF), advising governments in central banking and financial sector issues as well as in macroeconomic policy,

covering over 50 countries in Asia, the Middle East, Europe, and parts of Africa. He also brought expertise in Islamic finance issues based on his advisory work with many governments on risk management, governance, and regulation of Islamic finance. He joined Centennial as Director and Head of Financial Sector Practice and was the Deputy Director of the Monetary and Financial Systems Department at the IMF. He earned a PhD in economics from Harvard University and taught at New York University before joining the IMF in 1974.

Sami Al-Suwailem, obtained his bachelor's degree in science from King Saud University in Riyadh, Saudi Arabia, in 1987. He obtained his master's degree from Southern Illinois University in Carbondale, Illinois, in 1990, and in 1995 obtained his PhD from Washington University in St. Louis, Missouri, both in economics. He joined Al Rajhi Bank in 1995 as a chief consultant, and in 1998 became Manager of Research & Development in the Shari'ah Group at the Bank. He joined Islamic Development Bank Group in December, 2004 as a Senior Economist. Currently he is Head of the Financial Product Development Center at the IDB Group. He published several papers and books on Islamic finance in Arabic and English.

Dr. Hatim El-Tahir is a Director at Deloitte's Islamic Finance Group, and Leader of the Deloitte ME IFKC, a think tank and thought leadership initiative in Islamic finance aimed at prompting best practices in the industry.

Hatim worked extensively with regional and global Islamic financial institutions and leads the practice's development in MENA region and coordinates initiatives globally at Deloitte's member firms. His areas of specialisation include Islamic financial regulation, risk management, and Islamic finance research and education.

Hatim's experience spans many regions in the EMEA, including the United Kingdom, Africa, and 10 years in the GCC region. His recent representative accomplishments include advising on the development of a *takaful* act for an insurance regulator as well as leading a capacity development program in Islamic finance for a central bank in the Gulf.

He has authored numerous articles in credible industry journals, including Harvard University' *Islamic Finance Project* publication, and has been a regular speaker in major Islamic finance conferences, seminars, and training workshops.

Hatim is a regular participant in industry standards development discussions, exposure drafts, consultation papers, and task forces.

Richard Thomas OBE, is Chief Executive Officer of Gatehouse Bank plc. Gatehouse received its licence to operate as a *Shari'ah*-compliant investment

bank based in the City of London from the Financial Services Authority in April 2008.

In a career spanning over 35 years in merchant and investment banking in the City of London, Richard's last 30 years have been entirely in Islamic financial services and dedicated to establishing the Islamic economic model as viable in the heart of the City of London. Richard has previously worked for Saudi International Bank, United Bank of Kuwait, and Arab Banking Corporation (ABC), helping set up the Islamic asset management units in each one. He left ABC in 2007 to follow the vision of Mr. Ayman Boodai to set up GSH (UK) Ltd. and joined the foundation committee to set up Gatehouse Bank plc. from start up.

Richard is a Fellow of the Chartered Institute for Securities & Investment (CISI). He is the Chairman of the working groups UK Islamic Finance Secretariat. Richard is appointed by TheCityUK (TCUK) as Special Representative for Kuwait. In addition, he is an HMRC Tax Advisory Group member (IFS). He is also a British Expertise Advisory Council Member and a member of the Global Association of Risk Professionals (GARP).

In 2010, Richard received his Order of the British Empire, an honour bestowed by Her Majesty Queen Elizabeth II, in recognition for civic excellence and his contribution to the UK Islamic Financial Services industry.

Andrew White is the Director of the International Islamic Law & Finance Centre, Singapore Management University, where he is also an Associate Professor conducting research and teaching courses in Islamic Commercial Law and Islamic Finance, and coordinating the postgraduate specialised masters (LLM) in Islamic Law and Finance programme. An experienced lawyer and commercial arbitrator with nearly 30 years on the bar, Professor White also consults and conducts professional training programs for banks, regulators, and others in the Islamic finance industry. Professor White's recent international academic engagements include appointment in the University of Melbourne Law School (Senior Fellow), the University of Melbourne Centre for Islamic Law and Society and the Centre for Corporate Law & Securities Regulation, appointment as a Visiting Professor in the Faculty of Law of Universitas Islam Indonesia (UII), as well as in the Harun M. Hashim Law Centre, International Islamic University Malaysia (IIUM), and in the Faculty of Law of Gadjah Mada University (Indonesia). Professor White is also an Arbitrator for Islamic financial disputes with the Kuala Lumpur Regional Centre for Arbitration (KLRCA); an Adjudicator for Islamic financial disputes with the Singapore Financial Industry Disputes Resolution Centre (FIDReC), an Arbitrator with the Singapore International Arbitration Centre (SIAC), and a Fellow of the Singapore Institute of Arbitrators (SIArb).

Foreword

Islamic finance has continued to be the fastest growing sector of the international financial system. This growth has also been in quality and depth, resulting from a high degree of innovation that has kept pace with the new demands for financial products and services as economies continue to evolve and transform. Of significance is the greater abundance of profit-sharing and loss-bearing savings and investment products and other instruments that use structured finance. Given these developments, Islamic finance has demonstrated its potential to provide effective financial intermediation to meet the needs of a modern globalised financial system and economy.

While Islamic finance has shown its resilience and sustainability during this recent global financial crisis, the significant and rapid evolution of Islamic finance highlights the need for greater focus and attention on issues of prudential regulation, risk management, and overall financial stability. The evolving compendium of standards, codes, and principles from the Basel Committee on Banking Supervision, the Financial Stability Board, and other international standard-setting bodies has brought greater clarity and understanding to issues on the regulation and supervision of banks and financial institutions, including Islamic financial institutions.

However, given the uniqueness of *Shari'ah*-compliant modes of fund mobilisation, funding, and financing, the different financial stability and regulatory challenges may not be fully addressed by the global standards that have been issued. The Islamic Financial Services Board (IFSB) has addressed this in developing and contextualising the prudential, regulatory, and supervisory standards for Islamic finance. In addition, the work of the IFSB addresses the risk of *Shari'ah*–non-compliance and fiduciary risk, which are specific to Islamic finance, and complements the work of other international standard-setting organisations by bringing a valuable perspective to current and emerging issues.

The international standards are now being voluntarily observed in most nations of the world in efforts to build more resilient financial systems. The effective implementation of these international standards at a national level requires enabling banking and financial legislation that is responsive to market developments, and empowers authorities within a clear accountability

Islamic Finance: The New Regulatory Challenge.
Edited by Simon Archer and Rifaat Ahmed Abdel Karim
Copyright © 2013 by John Wiley & Sons Singapore Pte. Ltd.
ISBN: 978-1-118-62897-3

framework to act pre-emptively in addressing risks to financial stability. In Malaysia, the recent passage of the Islamic Financial Services Act will substantially strengthen the capacity of the regulatory authority to meet the challenges of the Islamic financial system.

The first edition of *Islamic Finance: The Regulatory Challenge* by Professors Simon Archer and Rifaat Ahmed Abdel Karim was an important addition to the literature on the regulation of Islamic finance. This second edition addresses the implications of the recent global financial crisis on the regulation of Islamic financial services. The book has dealt with the relevant regulatory issues in a timely manner and would be much welcomed by both practitioners and academics.

Dr. Zeti Akhtar Aziz,
Governor
Bank Negara Malaysia

Preface to the First Edition

There is now great interest, both in financial and legal circles, in reliable and authoritative texts on Islamic finance. I have no doubt that those who provide financial and legal services will warmly welcome the availability of *Islamic Finance: The Regulatory Challenge*. The work will be of great assistance to them.

The editors and the contributors write with great authority and clarity on a wide range of subjects, all of great relevance and interest. I am confident that those who read *Islamic Finance: The Regulatory Challenge* will find that they are fully equipped to deal with the many problems and issues that the book addresses. In the days of global financial markets, this subject is of the greatest importance and should not be neglected.

It is therefore very reassuring to know that in this book, there is now available the information necessary to all who are involved in financial markets. I am confident that this book will have the success it deserves.

PREFACE TO THE SECOND EDITION

When I wrote a preface for the first edition of this extremely useful book, I anticipated it would be of considerable value to those involved in the field of Islamic finance and that it would be a success. This has proved to be an accurate forecast, and six years later there is now a second edition.

I am delighted to welcome this new edition. In the period between the two editions—as is to be expected in the case of a subject, which, if it is no longer in its infancy, is a rapidly maturing adolescent—a great deal of experience has been acquired and many changes have occurred. In consequence, there is an even greater need than that which existed when the first edition was published for an up-to-the-minute and authoritative second edition for all those involved today in this important and growing area of finance. This book now meets that need, and I am confident it will succeed, as did the first edition. I wish it well.

Rt. Hon. Lord Woolf
Former Law Lord,
Master of the Rolls and
Lord Chief Justice of England and Wales

Islamic Finance: The New Regulatory Challenge.
Edited by Simon Archer and Rifaat Ahmed Abdel Karim
Copyright © 2013 by John Wiley & Sons Singapore Pte. Ltd.
ISBN: 978-1-118-62897-3

Acknowledgments

We would like to thank each of the contributing authors for taking the time to write their chapters. Their insights and practical experiences have made the book much richer.

Thanks also to Nick Wallwork and Ms. Gemma Rosey of John Wiley for getting the book into shape and guiding us through the publishing process.

Finally, we are indebted to our families, who have been a great source of encouragement and support in every step of the way.

Islamic Finance: The New Regulatory Challenge.
Edited by Simon Archer and Rifaat Ahmed Abdel Karim
Copyright © 2013 by John Wiley & Sons Singapore Pte. Ltd.
ISBN: 978-1-118-62897-3

PART

One

The Nature of Risks in Islamic Banking

CHAPTER 1

Supervision of Islamic Banks: The Regulatory Challenge—Basel II and Basel III

Simon Archer and Rifaat Ahmed Abdel Karim

1. INTRODUCTION

The documents of the Basel Committee for Banking Supervision (BCBS)—*International Convergence of Capital Measurement and Capital Standards: A Revised Framework* (generally known as Basel II) and the recently introduced new major set of reforms to Basel II, which are aimed at addressing global capital regulatory framework in light of the prevailing global crisis (and are generally known as Basel III)—present a real challenge to banking regulators and supervisors. This challenge is, of course, first and foremost in respect of the application of both documents to conventional banks. Basel II was issued in June 2004 (with some revisions in November 2005) to supersede the original 1988 Capital Accord (Basel I), while Basel III was issued in December 2010, with a revised version in June 2011.

The main innovations introduced in Basel II were, first, a significantly more comprehensive and sophisticated approach to measuring credit risk and, second, a capital requirement for operational risk. With respect to market risk, Basel II did not supersede the 1996 Amendment of Basel I, which had introduced a capital treatment for this category of risk not specifically covered in the original Capital Accord. The two approaches to market risk under Basel II, the Standardised Approach and the Internal Models Approach, are continued under Basel III.[1] However, while the scope of regulation has been extended under Basel III to liquidity risk, and the

Islamic Finance: The New Regulatory Challenge.
Edited by Simon Archer and Rifaat Ahmed Abdel Karim
Copyright © 2013 by John Wiley & Sons Singapore Pte. Ltd.
ISBN: 978-1-118-62897-3

regulatory capital requirements have been increased, and there have been some significant alterations and additions to Basel II regulatory environment, the Three Pillars of Regulation established under Basel II remain and indeed are enhanced under Basel III.

Basel I was a document of modest length that made no great technical demands on the reader. However, the years since 1988 have seen a very significant evolution in banking and finance, including the effects of the globalisation of financial markets and developments such as the abundance of derivatives and securitisations using structured finance. These developments have significant implications for risk and capital adequacy. Hence, Basel II, which (with its appendices) runs to over 250 pages, is a fairly daunting document that makes some nontrivial demands on the reader, both technical and conceptual.

On the other hand, the development of Basel III was mainly prompted by the recent financial crises, which started to take shape in 2007. Basel III emphasises not only the importance of the absolute amount of a bank's equity position, but most importantly the *quality* of capital held by these banks, two important issues that were not adequately addressed in Basel II.

The standards issued by the Islamic Financial Services Board (IFSB) have highlighted the fact that neither Basel II nor Basel III was (understandably) written with its application to Islamic banking in mind.[2] However, the rapid development of Islamic banking since the early 1990s, and the fact that international financial authorities such as the World Bank, the International Monetary Fund (IMF), and the BCBS understood the consequent desirability of building bridges between Islamic (*Shari'ah*-compliant) financial institutions and the conventional (*Shari'ah*–non-compliant) financial sector,[3] inevitably raised the issues of how and to what extent Basel II principles and techniques and those of Basel III are applicable to the regulation and supervision of Islamic banks, and of the regulatory and supervisory problems to be overcome in this context.[4] These issues constitute the concern of this book.

2. THE STRUCTURE OF BASEL II AND BASEL III: SUPERVISORY IMPLICATIONS

The structure of Basel II is based on three "Pillars." As mentioned above, these were retained and enhanced under Basel III. Pillar 1 deals with the new approach to credit risk, which replaces that of Basel I, and with operational risk; Pillar 2 addresses the supervisory review process from the standpoint of the responsibility of the supervisor to promote the overall safety of the banking system, and establishes a set of common guidelines for supervisory review, while also stressing the primary responsibility of individual banks

and the critical role of dialogue between supervisors and banks; and Pillar 3 lays down a minimum number of public reporting standards on risk and risk management intended to enhance the ability of market participants to be aware of a bank's risk profile and the adequacy of its capital in relation to this, thus involving the market in the capital adequacy regime. Building on the three pillars of the Basel II framework, Basel III supplemented the risk-based approach by introducing new regulatory requirements (notably concerning liquidity risk and the quantity and risk absorbency of capital) to promote a more resilient banking sector.

Basel II and Basel III thus present all banking supervisors with a major challenge, both in enforcing Pillar 1 together with the disclosure requirements of Pillar 3, and in implementing Pillar 2. The adoption of Basel II was not intended to be a requirement outside of the G10 countries represented on the BCBS, and then only for banks that are internationally active. However, as Basel I had been adopted in more than 100 countries, the supervisors in these and other countries may be expected to adopt both Basel II and Basel III progressively over the next few years. The G10 was broadened to include additional members and renamed G20. Following the financial crisis that began in 2007, the G20 gave more powers to the Financial Stability Board (formerly the Financial Stability Forum), which, *inter alia*, include oversight over the implementation of Basel III. The membership of the Financial Stability Board includes, among other standard-setting bodies, the BCBS.

For supervisors in countries where Islamic banks are located, there is the further challenge of applying Basel II and Basel III to those institutions. This added challenge results from the specificities of the Islamic (*Shari'ah*-compliant) modes of finance employed by Islamic banks. These raise issues of capital adequacy, risk management, market discipline, and corporate governance that differ significantly from those that arise in conventional (*Shari'ah*–non-compliant) financial institutions. The issues concern the types of assets to which Islamic financing gives rise, the related risks and the availability of risk mitigants, and the types of non-interest-bearing savings and investment products offered by Islamic banks for funds mobilisation in place of conventional deposit and savings accounts. The fact that these non-interest-bearing savings and investment products have characteristics similar to those of collective investment schemes, not normally the concern of banking supervisors or regulators, constitutes a further regulatory challenge.

3. THE ISLAMIC FINANCIAL SERVICES BOARD

The Islamic Financial Services Board (IFSB) was launched in 2002 by a consortium of central banks and the Islamic Development Bank (and with

the support of the IMF) with the mandate to provide prudential standards and guidelines for international application by banking supervisors overseeing Islamic banks.

In December 2005, the IFSB issued two prudential standards for Islamic banks that are designed to help supervisors of such banks meet the challenge of implementing Basel II, one on capital adequacy and one setting out guiding principles of risk management. A third standard on corporate governance was issued in 2007.[5] The mandate of the IFSB was extended in December 2005 to the domains of insurance and securities market supervisors and regulators.

The main challenge for the IFSB is to develop a framework that is common and applicable to all jurisdictions. However, unlike the Basel Committee, which can rely on regulatory frameworks and best practices developed by other leading regulators and banks as a background to its global framework, this process could not be readily applied by the IFSB. This is because the IFSB does not have the privilege of borrowing ideas from a large number of countries that have developed robust regulatory frameworks specifically for Islamic banks. Hence, the onus is on the IFSB to develop most of the thinking to set internationally accepted common prudential standards for Islamic financial institutions. This involves identifying the risks in the different types of Islamic finance and activities, understanding the substance as well as the form of the contracts that govern the transactions, dealing with issues that have not been addressed in other international standards, safeguarding the interests of other stakeholders who in principle share asset risks with the shareholders, and adapting *Shari'ah* rules that would be acceptable to the majority of its members.

In addition, whereas after the financial crises the Financial Stability Board has been given more powers to enhance the implementation of Basel III, the IFSB, according to its Articles of Agreement, can only recommend its standards to be adopted.

4. CONTENTS OF THIS BOOK

Since this book deals with a large range of regulatory issues arising from the application of Basel II and Basel III to Islamic banks, authors who have been chosen are specialists drawn from a variety of relevant backgrounds: banking and capital markets supervisors; the legal and accounting professions; banks and financial institutions; and academia. The book is organised into four main parts, reflecting different aspects of the regulatory challenge, and a concluding chapter, as outlined below.

Part One: The Nature of Risks in Islamic Banking

Part One consists of 12 chapters, this overview of the book being the first. In Chapter 2, Brandon Davies examines banking and the risk environment. He looks at the regulatory developments that have recently taken place following the financial crisis that started in 2007. The risk characteristics of Islamic products, and the complexities of some of these, such as the phenomenon of displaced commercial risk, are rigorously examined in Chapter 3 by Venkataraman Sundararajan. Chapter 4, by Sami Al-Suwailem, highlights the benefits that can in principle be derived from Islamic finance in light of the recent financial crisis, especially in enhancing global financial stability. The chapter points out how Islamic finance provides a framework for balancing the relationship between risk and returns, which, as Sami reminds us, requires careful and proper implementation to be practically relevant.

Chapter 5, written by the two editors of this book, Simon Archer and Rifaat Ahmed Abdel Karim, examines issues of capital structure and risk in Islamic banks and *takaful* insurance firms. Simon and Rifaat point out that the capital structures of both Islamic banks and *takaful* undertakings present complexities not found in the case of conventional financial institutions. With respect to the former, Archer and Karim show how capital structure and risk are linked, from a regulatory perspective, via risk weightings and capital requirements set out by the IFSB based on the Basel II and III Accords and the Standardised Approach to risk weighting. They highlight specific risks in contracts used by Islamic banks and the implications in these contracts for the capital requirements, and in some cases the capital structure, of these banks. With regard to *takaful* firms, Archer and Karim show how the regulatory capital of a *takaful* undertaking needs to meet the solvency requirements of the insurance operations, and how the *takaful* operator needs capital to cover its own business risks, especially the risk of its management fees being insufficient to cover its operating expenses and the "underwriting management risk" potentially arising from failure in its fiduciary duties in managing the underwriting of the Policyholders' Risk Fund.

The next several chapters focus on specific types of risk facing Islamic banks. In Chapter 6, John Lee Hin Hock examines credit and market risks inherent in asset-side products. He shows how Islamic financing assets possess risk characteristics not found in conventional loans, including combinations of credit and market risks. In Chapter 7, Simon Archer and Abdullah Haron analyse consequential or operational risks. For Islamic banks, as they point out, operational risks include those that may arise from errors in drawing up contracts or in executing transactions that result in non-compliance with the *Shari'ah*, which may have serious financial consequences. Chapter 8, by Samir Safa, sheds light on information technology

risk, a type of operational risk to which Islamic banks are particularly exposed. Samir claims that the lack of systems that *genuinely* comply with *Shari'ah* standards and principles (i.e., systems that are built with the primary purpose of supporting the Islamic finance operating model), seems to have forced the majority of the Islamic financial institutions to adopt conventional banking operational systems that were available in the market. This has greatly contributed, Samir argues, to amplifying the elements of information technology risk that Islamic banks face.

Chapter 9, by Yusuf Talal DeLorenzo and Michael J. T. McMillen, and Chapter 10, by Andrew White and Chen Mee King, deal with a complex and daunting set of risks arising from *Shari'ah* and legal compliance requirements and their interactions, which result *inter alia* in legal impediments to the development of Islamic securitisations. Chapter 9 also provides a historical outline, from a legal perspective, of the emergence of modern Islamic banking and finance.

In Chapter 11, Mohamad Akram Laldin addresses another type of operational risk, *Shari'ah*–non-compliance risk, which is unique to Islamic financial institutions (IFIs). *Shari'ah* must be the substance of, and provide guidance for, the day-to-day operations and activities of these institutions. The *Shari'ah* compliance of an Islamic financial institution, the author argues, is crucial to ensuring the confidence of IFI shareholders as well as that of the public in the authenticity of that institution, which in turn, will affect the profitability of the IFIs' business in the future through its ability to attract and retain funds from the public. A serious lapse in *Shari'ah* compliance could lead to withdrawals of funds and other loss of business that could plunge the IFIs into crisis. For that reason, *Shari'ah*–non-compliance risk is arguably a higher priority category of risk for IFIs than other identified risks. In December 2009, the IFSB issued the *Guiding Principles on* Shari'ah *Governance Systems*, which delineates a system of internal control over *Shari'ah* compliance, comprising a continuous internal audit process and an annual review.

Finally, Peter Casey in Chapter 12 considers the implications of these risks in the wake of the financial crisis for a financial sector regulator. In particular, Peter examines the supervisor's role in *Shari'ah* matters. He argues that in the case of a firm that claims to be Islamic, the regulator should focus on requiring that the IFI have a sound internal system to ensure *Shari'ah* compliance, on which the regulator may rely while avoiding the role (for which it is not equipped) of judging the *Shari'ah* compliance of the IFI. In such a system, the regulator may impose *Shari'ah* governance requirements on the firm. Implicit in this system is that the supervisor will apply an approach similar to those it would apply in other (nonreligious) control areas, with the aim of achieving compliance with religiously based requirements.

Part Two: Capital Adequacy

Part Two contains four chapters. Chapter 13, by John Board and Hatim El-Tahir, examines the need for bank capital in order to absorb the economic risks of banking. Their chapter touches on two inter-linked developments in capital regulation: first, the globalisation of financial regulation and the impact of the global regulatory framework proposed in Basel III, which aims at promoting a more resilient banking sector worldwide; second, the development and limitations of new forms of capital instruments (contingently convertible or subordinated) introduced by some major financial institutions, including notably systemically important financial institutions (SIFIs) on a global scale. Chapter 14, by editors Simon Archer and Rifaat Karim, highlights an important set of issues concerning the measurement of risk for capital adequacy purposes that results from the use by Islamic banks of profit-sharing and loss-bearing investment accounts in lieu of conventional bank deposit and savings products. In Chapter 15, Sandeep Srivastava and Anand Balasubramanian deal with the measurement of operational risk for capital adequacy purposes under Basel II and Basel III. With respect to Islamic banks, Sandeep and Anand point out that Islamic banks are subject to different types of operational risks, for example, risk of *Shari'ah*–non-compliance, fiduciary risk, and risks arising out of the complex documentation involved in Islamic products. However, Sandeep and Anand claim that these unique risks of Islamic banks do not necessarily mean that these banks require different methodologies for measuring operational risk. Finally, in Chapter 16, Richard Thomas examines liquidity risk, an issue that Basel III addresses in depth, in Islamic banks. He highlights the liquidity management challenges, which Islamic banks face in light of the shortage of adequate high quality *Shari'ah*-compliant financial instruments. This challenge has been further complicated by the Basel III requirement for the "high quality liquid assets" that banks should hold to manage their liquidity risk. Accordingly, Richard argues that the handicaps which Islamic banks face in managing liquidity risk should be addressed by national authorities (so as to provide *Shari'ah*-compliant substitutes for the conventional interbank markets and lender-of-last-resort facilities), as well as by the global regulators and notably the BCBS in terms of what may count as "high quality liquid assets."

Part Three: Securitisation and Capital Markets

Part Three consists of three chapters. Chapter 17, by Baljeet Kaur Grewal, deals with the developing phenomenon of securitisations in Islamic finance, or *sukuk*. She provides a market overview of the issuance of *sukuk* in various jurisdictions, as well as their potential. Baljeet argues that although conventional bonds and

sukuk share a similar process, structure, and end result, there are a few key *Shari'ah* principles, which must be adhered to, that differentiate the two types of securities. She gives examples of the common *sukuk* structures that have been used in the market. In Chapter 18, Prasanna Seshachellam considers the opportunities and challenges in the Islamic capital and money markets, and particularly the need to create a *Shari'ah*-compliant asset base and financial infrastructure for the creation of liquid *Shari'ah*-compliant assets. Prasanna also discusses the primary developments required to improve Islamic capital markets in general and those that are specifically required to improve the ability of Islamic capital markets to provide liquidity, which include, *inter alia*: (a) a robust and wide suite of credible *Shari'ah*-compliant products; (b) a stronger market infrastructure; and (c) measures (i) to attract a wider set of investors, (ii) to reduce uncertainty regarding market practices and instruments, and (iii) to achieve a robust and reliable regulatory framework. In Chapter 19, Nik Ramlah Mahmoud discusses the regulation of Islamic capital markets, pointing out that the regulation of the Islamic capital markets poses several unique challenges as compared to the regulation of Islamic banking and *takaful*. Nik Ramlah argues that the fundamental challenge in regulating Islamic capital markets is whether or not the objectives and requirements of *Shari'ah* are compatible with the underlying principles of general securities regulation. She discusses various approaches that are adopted (mainly in Malaysia) in the regulation of ICM.

Part Four: Corporate Governance and Human Resources

This part contains four chapters. The first, Chapter 20 by Carol Padgett, considers some of the common features of corporate governance regulations affecting companies across the globe, as well as banks as a special case. She considers the guidance published by the Basel Committee on Banking Supervision on corporate governance in banks, where she focuses on recent changes in that guidance as it affects risk management, remuneration practices, and transparency in banking structures. Carol also highlights how the recent banking crisis exposed shortcomings in each of these areas. Chapter 21, by the editors, examines specific corporate governance issues in Islamic banks, notably those raised by the requirement for compliance with the *Shari'ah*, and those resulting from the use by Islamic banks of profit-sharing and loss-bearing savings and investment products in place of conventional deposit and savings accounts. In Chapter 22, Daud Abdullah (David Vicary) considers the transparency and market discipline implications for Islamic banks of Basel II Pillar 3, as well as the developments that have been introduced in Basel III, indicating the potential

key role of the regulator in promoting or "bootstrapping" a virtuous circle of transparency. He also incorporates in his discussions the IFSB guidance on disclosures to promote transparency and market discipline for Islamic banks.[6] In Chapter 23, Volker Nienhaus examines the human resource management implications of the conceptual and technical challenges facing the Islamic banking sector, including the need to recruit, train, motivate, and retain highly competent personnel in an environment rendered highly competitive by rapid growth and the presence of the major international banks.

Part Five: Conclusion

In the fifth and final section, Chapter 24, the editors present some overall conclusions.

NOTES

1. For more details on Basel III, see in this volume Chapter 2 by Brandon Davies and Chapter 13 by John Board and Hatim Al-Tahir.
2. The article in *The International Journal of Bank Marketing* by Karim (1996), one of the editors of this book, was the first publication to highlight the fact that Basel 1 (the Basel Accord) could not be applied to Islamic banks without taking into consideration the specificities of these banks. This prompted the issuance of a document by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) (1999), which was mainly drafted by Simon Archer and Rifaat Ahmed Abdel Karim, the co-editors of this book.
3. In part, this was due to a series of conferences organised by Rifaat Ahmed Abdel Karim, co-editor of this volume, then Secretary-General of AAOIFI, notably the *Conference on Regulation of Islamic Banking* held in February 2000.
4. The essential differences between conventional and Islamic financial intermediation are explained by Venkataraman Sundararajan in Chapter 3 of this volume.
5. The IFSB standards on the supervisory review process (Pillar 2) and transparency and market discipline (Pillar 3) were issued in 2006.
6. IFSB-4. 2006. *Disclosures to Promote Transparency and Market Discipline for Institutions Offering Islamic Financial Services (Excluding Islamic Insurance (Takaful) Institutions and Islamic Mutual Funds)*. Kuala Lumpur: IFRB.

REFERENCES

Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI). 1999. *Statement on the Purpose and Calculation of the Capital Adequacy Ratio for Islamic Banks*. Manama, Bahrain: AAOIFI.

Islamic Financial Standards Board (IFSB). 2009. *Guiding Principles on Shari'ah Governance Systems for Institutions Offering Islamic Financial Services*. Kuala Lumpur, Malaysia: IFSB.

Karim, R.A.A. 1996. "The Impact of the Basle Capital Adequacy Ratio Regulation on the Financial and Marketing Strategies of Islamic Banks." *The International Journal of Bank Marketing* 14 (7): 32–44.

CHAPTER 2

Banking and the Risk Environment

Brandon Davies

1. THE GLOBAL RISK ENVIRONMENT

We live in interesting times. The global economy has changed significantly in the last decade. Emerging market economies have increased their share, for much of that time, of a rapidly expanding global economy, from around 25 percent to around 50 percent of global GDP (measured at purchasing power parity).

Growth has not, however, been evenly distributed. Developed economies that have been globally dominant in both economic and political terms for much of the period since World War II have increasingly suffered, since the turn of the millennium, from low rates of economic growth. This has been especially true since they entered a recessionary period, which we may date from the collapse of the U.S. investment bank Lehman Brothers in 2007.

The collapse of Lehman Brothers itself was consequential upon the collapse of the U.S. mortgage-backed securities (MBS) market. This collapse brought about a general reduction in the supply of liquidity across the interconnected banking systems of many developed economies, as banks restricted their lending to each other, fearful of which banks might be exposed to the very large credit losses from their holdings of MBS and other similar collateralised debt obligations (CDO).

As a number of very large international banks suffered from both high credit losses and illiquid markets, they were unable to fund their balance sheets and had to be funded and recapitalised by the governments of the countries of their incorporation. The largest of all was Royal Bank of Scotland (RBS), which shortly before the crisis was the world's largest bank as measured by assets. RBS had to be recapitalised by the UK government, which acquired some 80 percent of the bank's share capital. In some countries, most notably the Irish Republic, the recapitalisation of the countries' banks placed great strain upon their national treasuries.

Islamic Finance: The New Regulatory Challenge.
Edited by Simon Archer and Rifaat Ahmed Abdel Karim
Copyright © 2013 by John Wiley & Sons Singapore Pte. Ltd.
ISBN: 978-1-118-62897-3

The increase in government debt associated with bank recapitalisation was combined with the much greater government debt resulting from the deficit spending by countries acting to counteract the recessionary effects of the contraction of bank credit (and therefore of the money supply) by their troubled and in many cases bankrupt banking systems. This resulted in the doubling of government debt to GDP ratios in many developed economies, in many cases rising to levels not seen since World War II.

In the euro area, the recession also highlighted weaknesses in the structure of its monetary system. The effective fixing of exchange rates between the very different national economies had initially led to each member country being able to borrow as though there were little if any differential credit risk between the individual member countries. Thus, at its most extreme, Greece was able to borrow at a very small premium to Germany. The recession across the euro area, however, soon resulted in member countries' relative economic competitiveness (and hence creditworthiness) becoming obvious. It became clear that whilst Germany was very competitive and able to increase exports, most especially to emerging market economies such as China and India, many other member states were not so internationally competitive. Thus, in spite of significant reductions both in government spending and in wages and employment conditions in the economy as a whole, it was unlikely all euro area countries could service all of the debts their respective governments had incurred.

The fundamental economic position of these euro area countries was made worse by the treaty limitations on the European Central Bank (ECB), which despite its title does not have the intervention powers of a traditional national central bank to underwrite national debt by the direct purchase of government bonds. This limitation, appeared to have been greatly aggravated by the reluctance until very recently (as of April 2012) of the German government to allow the ECB to use the powers it does have to intervene in government bond markets on anything like the scale of the Federal Reserve Bank in the United States or the Bank of England in the United Kingdom.

The final outcome of what is, at the time of writing, a continuing crisis cannot be predicted. A number of lessons have, however, been learned, especially in respect of the risks inherent in a fractional reserve banking system. The most important of these are:

- The need for banks to hold sufficient high quality capital against the credit, market, and operational risks of the banking system.
- The over-reliance of commercial banks on their ability to turn banking assets into cash through markets (market liquidity).
- Commercial banks' need to ensure that they reduce the extent of their mismatches between the term structure of maturities of banks' assets and liabilities (funding liquidity).

These risks are not new to banking. However, new regulation—most especially in the shape of the new international standard, Basel III—and the concerns of governments and bank shareholders to ensure that banks are economically more robust against multiple financial risks into the future are ensuring that banks focus on these risks and strengthen their capital and liquidity structures.

2. THE REGULATORY ENVIRONMENT

The regulator's reaction to the risk environment in banking has been developed on a global basis through the development of the Basel III Accord on which it is expected global banking regulation will be based, though there are some exceptions to this, most notably in the United States with the Dodd-Frank Act and lately in the United Kingdom where banks will be subject to the implementation of the recommendations of the Independent Commission on Banking (ICB) as well as to the European Union (EU) implementation of Basel III through the fourth Capital Requirements Directive (CRD IV). The CRD IV has the force of law throughout the EU and this is likely to maintain its leading role in both developing and implementing the Basel Accords.

The risk basis of regulation has been further developed under Basel III, and whilst there have been some significant alterations and additions to the previous Basel II regulatory environment, the Three Pillars of Regulation established under Basel II remain and indeed are enhanced under Basel III.

2.1 Pillar 1—Minimum Capital Requirements

Requires computation of minimum capital requirements for credit risk and operational risk (in addition to market risk under 1996 amendment).

Individual capital weights, however, differ significantly between Basel II and Basel III, with much higher weights for traded assets, assets subject to securitisations, derivative transactions, and more contentiously for the short term (under one year) funding of trade in goods and services.

Pillar 1 Credit Risk Pillar 1 allows for three possible approaches to the computation of a bank's credit risk. These approaches are the:

1. Standardised approach
2. Internal ratings–based (foundation) approach
3. Internal ratings–based (advanced) approach

The standardised approach is computed primarily from the use of public ratings and is basically an enhanced version of the Basel I regime. The

internal ratings–based (foundation) approach is based upon the use of a standardised model incorporating three main factors:

1. The probability of default (PD)
2. Exposure at default (EAD)
3. Loss given default (LGD)

The third methodology is the internal ratings–based (advanced) approach, which draws on a bank-specific grading model. These models specifically do not, in their grading computations, take into account the portfolio effects that may come from the correlation between individual credits within a portfolio or from the relationships between portfolios of credit risk assets.

This does open up the issue of how such an approach can pass the "usage test" for such models, as many banks using advanced models will design the model to inform the bank of the addition to (or reduction from) total risk as a result of the purchase (or sale) of the asset. Such a risk measure requires the model to compute the assets risk, taking into account the portfolio of risk the bank has. The model will clearly and correctly show a different level of risk from the same asset across different banks with different portfolios (see Section 3 later).

Stress tests play an important role in determining capital requirements across all asset classes under Basel III, as regulators are looking to ensure bank capital levels are sufficient under such circumstances. Stress test models usually incorporate correlations both within and across asset classes. These correlations will change during stress circumstances, often rising steeply. This effect is known as dynamic conditional correlation.

Credit Risk Grading Models There are three main approaches to the development of the credit models to support either of the internal ratings–based approaches for the grading of corporate credits, modified versions of which can be used to determine the relative standing of sovereign credits.

1. Financial ratio models, which come in two main forms, univariate and multivariate, the best known of these models being the "Z Scores" model developed by Edward I. Altman, though many applications of Altman's techniques now exist, including many industry-specific models.
2. Option-based models, which characterise a corporate loan as if it were a put option written from the bank to the borrower that allows the borrower to put the assets of the company to the lending bank once the company's value falls below the level of its debt. These models were first developed by the economist Robert C. Merton, and commercial

versions were further developed by the KMV company that is now a part of Moody's, the major public ratings agency.
3. Reduced form (empirical) models, which were developed by Robert A. Jarrow. These models were based upon observing the credit spreads between different corporate bonds and the sovereign bonds of the applicable national government.

For all credit models Basel II requires that any model used must create a minimum of eight credit grades and must be capable of being mapped to publicly available credit grades. The reliance on such public credit grades has become more controversial in Basel III, as the main rating agencies had a poor record of grading credit across a wide spread of asset-backed securities (ABS) from the early stages of the financial crisis of 2007 on.

In the personal sector, the equivalent of these models is the use of credit scoring models, which look at a series of factors affecting a person's ability to service debt to create the equivalent grading system. Such models often have highly granular structures with so called cut-off points, which determine the mapping of these models to historic defaults.

The gradings produced by all of these models can be affected by the provision by borrowers of collateral, and Basel III has a greater degree of recognition of a range of collateral and its ability to mitigate credit risks than was allowed under Basel II.

Owing to the particular problems associated with the misleading credit gradings provided by major public rating agencies to a broad swathe of securitised asset structures leading up to the financial crisis, there are under Basel III effectively a series of surcharges added to the capital requirements of grading model outturns as applied to securitised products.

Pillar 1 Operational Risk Operational risk is defined as "the risk of loss from inadequate or failed internal processes, people and systems or from external events."

As with credit risk, there are three approaches to the computation of bank capital required to back operational risk:

1. The *basic indicator approach*, which applies a fixed percentage (15 percent) of gross income (av. over three years).
2. The *standardised approach*, which divides the business into eight business lines: corporate finance, trading and sales, retail banking, commercial banking, payment and settlement, agency services, asset management, and retail brokerage. To each of these business lines a different percentage of capital is applied, between 12 and 18 percent.

3. The *advanced measurement approach*, which comprises three main techniques: the internal measurement approach and the loss distribution approach (both of which mirror the model-based credit measurement approaches above), and the risk drivers and controls approach (a scorecard-based approach, which for example places scores against factors such as the bank's internal controls and the risks the bank runs by types of risk events that the bank may experience).

All approaches must be capable of mapping losses to the eight business lines (above) and risk event types (internal fraud; external fraud; employment practices and workplace safety; clients, products, and business practices; damage due to physical assets; business disruption and system failure; and execution, delivery, and process management).

Management and control processes are capable of being scored by using key risk indicators (KRI) and through techniques such as Six Sigma, which score processes by looking at measurement against "best practice," such as the number of rejected applications for credit due to inadequate data collection.

Operational risk measurement produces a number of challenges that do not apply to credit or market risk.

- In data collection, there is the need to collect data on what are often termed "near misses." The relevance of this can be seen, for example, in the collection of data on the number of times a mistake between the back and front offices in a dealing room results in a sale of USD against EUR being recorded as a purchase. If only the losses resulting from such a mistakes were recorded then there could be a significant under-recording of the number of mistakes being made.
- It can often be very difficult to determine the root cause of a particular operational risk incident. Is improper recording of a transaction a failure of training or of process? Are the IT systems at fault or are administrative policies not being embedded in operational procedures? Establishing a process for "root cause analysis" is vital to ensuring operational risks are properly recorded and the appropriate corrective action taken.
- There are reasons to suppose that the severity of operational risk events is systematically increasing, as greater reliance on automated IT systems means that when the system fails it will fail continuously. Other risks come from outsourcing, terrorism, and globalisation.

Pillar 1 Market Risk The two approaches to market risk under Basel II are continued under Basel III. The simplest approach is the *standardised approach*, which consists of a set of capital additions required to address the

exposures banks run to market risk. The process consists, in essence, of a number of "look-up tables" where capital is computed from the market positions run by the bank on both a net and gross basis. The latter has risen in importance, as the economic crisis of 2007 illustrated the importance of understanding counterparty credit risk and what can happen to the market exposures of a bank should a counterparty to a hedging transaction fail.

The issue of counterparty risk has indeed been a major driving force behind a number of reforms to derivatives trading, in particular where the market was dominated by transactions directly undertaken between banks. This over the counter (OTC) market created difficulties both for banks and regulators when they needed to understand the exposure any single counterparty institution had to other parties in the market. The main counterparty in a number of derivative transactions was found to be American Insurance Group (AIG), apparently much to the surprise of the U.S. regulators. Proposals under Basel III will result in the establishment of central clearing through so-called central counterparty clearing (CCPs) for most derivatives transactions in the future, making the exposures of institutions more transparent.

The second approach, one used by many banks, is the *internal models approach*. Under this approach, the regulators agree to the bank's own models, much as they do for the internal ratings–based (advanced) approach for credit risk and the advanced measurement approach for operational risk.

Key elements of market risk models are:

- Calculation of the statistical parameters that describe the predicted movement in market prices.
- Statistical assumptions about the way in which prices will move in the future.
- Accuracy of the valuation process applied to the portfolio for each future scenario.

For the regulators to approve the model, it must fit with their model approval criteria, which has the following tests for the bank's risk management system:

- The system is conceptually sound and implemented with integrity.
- The bank has sufficient staff trained in the use of sophisticated market risk management models (there must be skilled staff in the following key areas: trading, risk control, audit, and operations).
- Its models have a proven track record of measuring risk with reasonable accuracy.
- It carries out regular stress testing.

2.2 Pillar 2—Supervisory Review

Supervisory review is designed to:

- Uncover any capital requirements above the minimum level computed under Pillar 1 (e.g., due to excessive concentrations of risk).
- Uncover early actions that may be required to address emerging risks (e.g., growing backlogs of outstanding reconciliations).
- Closely follows current U.K. and U.S. practice.

It also introduces the computation of each individual bank's capital and liquidity through the Individual Capital Adequacy Assessment Process (ICAAP) and the Individual Liquidity Adequacy Statement (ILAS).

Pillar 2 The Supervisory Review Process Pillar 2 addresses three main areas of risk either not covered or outside of the scope of Pillar 1:

1. Risks not fully considered in Pillar 1, such as credit concentration risk.
2. Risks not considered at all by Pillar 1, such as reputation risk.
3. Compliance with the minimum standards set for the use of more advanced methods of calculation in Pillar 1.

Pillar 2 identifies four core principles of supervisory review:

- Principle 1—Banks should have a process for assessing their overall capital adequacy in relation to their risk profile and a strategy for their capital levels.
- Principle 2—Supervisors should review and evaluate banks' internal capital adequacy assessments and strategies, as well as their ability to monitor and ensure their compliance with regulatory capital ratios. Supervisors should take appropriate supervisory action if they are not satisfied with the result of this process.
- Principle 3—Supervisors should expect banks to operate above the minimum regulatory capital ratios and should have the ability to require banks to hold capital in excess of the minimum.
- Principle 4—Supervisors should seek to intervene at an early stage to prevent capital from falling below the minimum levels required to support the risk characteristics of a particular bank and should require rapid remedial action if capital is not maintained or restored.

These principles clearly indicate why supervisors are looking for banks to establish economic capital models (see Section 3 below).

2.3 Pillar 3—Market Discipline

Pillar 3 is the so-called market discipline pillar.

The Bank for International Settlements (BIS) defines *market discipline* as "the internal and external governance mechanism in a free market economy in the absence of direct government intervention."

Market discipline is designed to help a bank's shareholders and market analysts and to lead to greater transparency on issues such as a bank's:

- Asset portfolio.
- Risk profile.

Pillar 3 Disclosure The aim of Pillar 3 is to use the market discipline imposed by Basel III disclosure requirements to complement the operation of Pillars 1 and 2.

The Pillar 3 disclosure information is focused on capital adequacy information, not financial performance, and falls into the following main areas:

- The structure of capital.
- The risk exposures.
- The level of capital adequacy.

There is an extensive list of quantitative and qualitative disclosures under each area.

Whilst Basel does not require the disclosures to be reconciled with the bank's financial accounts in a number of jurisdictions this will in practice be necessary due to the requirements of bodies responsible for financial reporting, such as government bodies and listing authorities.

The main areas for enhanced disclosure are:

- The structure of capital.
- The adequacy of capital.
- The risks to which banks are exposed, as well as the policies and techniques banks use to identify, measure, monitor, and control these risks. The disclosure must cover credit, market, and operational risks as well as interest rate and equity risks held in the banking book.
- Credit risk–specific disclosures, including total credit exposure and its distribution by product and by geography, industry, and maturity, as well as impaired loans and provisions relating thereto. Banks must also

disclose their use of credit mitigation techniques such as netting or collateralisation and how such techniques are applied.
- Securitisation, banks undertaking securitisations, and/or investing in securitisations have additional disclosure requirements.
- Market risk by interest rate risk, equity position risk, foreign exchange risk, and commodity risk
- Operational risk, where the technique used must be disclosed.

Disclosures also differ significantly depending on whether a bank is using the standardised or either of the internal ratings-based approaches to calculating credit risk or is using models for market risk, in which cases significant disclosures of the model approach, its calibration, and its testing should also be disclosed.

2.4 Liquidity Risk

Both Basel I and Basel II had little to say on liquidity risk. This may in part have been due to an increasing academic fashion for assuming markets were characterised by plentiful and always available sources of funding, a corollary of the "efficient market hypothesis." Indeed, in the decade before the 2007 Lehman crisis, markets had been a ready source of liquidity for bank assets through the rapidly growing asset repurchase (repo) and securitisation markets. The demise of Lehman resulted in a rapid and general decline in the availability of funding to virtually all bank asset markets, as the value of bank assets and the solvency of a number of banks were increasingly called into question.

The new Basel III regulatory proposals attempt to address this deficiency and to improve the liquidity position of banks by:

- Curbing their ability to create a large maturity mismatches, including the imposition of a "stable funding ratio."
- Ensuring that over a 30-day period they have a positive daily cash flow (i.e., their daily "cash inflow" from *inter alia* maturing assets and contracted funding is greater than their daily "cash outflow" from *inter alia* contractual lending obligations and maturing deposits).
- Ensuring banks hold a quantity of high quality liquid assets (HQLA) that can be turned into cash through markets and in need through the opening of a discount "window" at the central bank. This is called a "stock" liquidity requirement.

Under Basel III there is in general a greater emphasis on banks' funding liquidity and specifically upon the retail deposit base as a stable source of funds.

The use of government bonds as the major source of HQLA to meet their "stock" liquidity requirement is, however, being increasingly called into question, as the very high national debt to gross domestic product (GDP) ratios of a number of major economies, combined with poor GDP growth prospects, have resulted in their government bonds being downgraded from AAA status. The United States was a recent and extremely important example of this when, in August 2011, Standard & Poor's, the United States–based major rating agency downgraded U.S. government debt from AAA to AA+; U.S. debt has also been downgraded by both a German and a Chinese rating agency.

In the euro area in January 2012, S&P stripped its AAA rating from France and downgraded eight other Eurozone countries. Moreover, the effective default of Greece in 2012 on its national debt has dealt a major blow to the whole idea that euro area countries can rely on their central bank (the ECB) to undertake market actions to ensure national debt is repaid, at least in nominal terms.

As a result of these problems it is increasingly clear that government bonds cannot simply be accepted as credit risk free, and certainly not in the case of euro area governments, which lack the ability to control the issue of their own currency. Losses for many banks on their holding of euro area government bonds are already substantial, as such bonds are accounted for as either "held for trading purposes" or "available for sale" under International Financial Reporting Standards (IFRS) and are therefore either marked to market through the profit and loss or capital accounts, and the bonds are generally medium or long term. This accounting treatment leads to very large adjustments to profit and loss and/or the bank's capital as the credit spreads on these bonds widen. Because of the extent of exposure of many European banks to their national governments, this is now requiring some major European banks to undertake extensive recapitalisation.

This should lead to some rethinking of the Basel III liquidity rules, as they clearly fail to fully recognise the risks inherent in banks holding large quantities of government bonds as encouraged by the new Basel III "stock" liquidity regime. A rethink may indeed prove a good basis for a more inclusive set of global banking liquidity rules that would level the playing field between *Shari'ah*-compliant and conventional banks (see Sections 5.2 and 5.3).

2.5 Leverage Ratio

Basel III also introduces a simple Leverage Ratio at 3% (Total Tier 1 Capital / Total On and Off Balance Sheet Exposures). The 3% ratio requirement will parallel run from 1 January 2013 to 2017, meaning that the Committee will track the ratio, its component factors, and impact over this period and will require Bank level disclosure of the ratio and its factors from 1 January 2015.

Based on the results of the parallel run, final adjustments to the ratio will be carried out in the first half of 2017, and it will be fully effective from 1st January 2018.

2.6 The Basel III Liquidity Regime: The Liquidity Coverage Ratio (LCR)

The LCR has two components:

a. the value of the stock of high quality liquid assets (HQLA) and
b. total net cash outflows, and is expressed as:

$$\frac{\text{Stock of HQLA}}{\text{Total net cash outflows over the next 30 calendar days}} \geq 100\%$$

HQLA are comprised of Level 1 and Level 2 assets, with Level 2 assets comprising Level 2a and Level 2b.

The high quality liquid assets included in the Liquidity Coverage Ratio (LCR) are:

Level 1 assets: (i) cash (ii) central bank reserves (iii) high quality marketable securities backed by sovereigns and central banks, all subject to no haircut;

Level 2a assets: (i) lower quality government bonds (ii) covered bonds (iii) at least AA-rated corporate bonds, all subject to a 15 percent haircut;

Level 2b assets: (i) corporate debt securities that are rated A+ to BBB–, actively traded and a proven source of liquidity even under stressed market conditions, subject to a 50 percent haircut (ii) unencumbered equities issued by nonfinancial entities that are exchange traded, centrally cleared, and a constituent of the major stock index where the liquidity risk is taken are denominated in the same currency as the liquidity risk and are a proven source of liquidity under stressed conditions, again subject to a 50 percent haircut (iii) high quality residential mortgage-backed securities (rated AA or higher, and with underlying mortgages having a maximum 80 percent LTV on average at issuance) and liquid (actively traded and a reliable source of liquidity even in stressed conditions), subject to a 25 percent haircut.

After the application of the haircuts, Level 2b assets cannot exceed 15% of a bank's total high quality liquid assets, and they count towards the limit

that the total amount of Level 2 assets (Level 2a plus Level 2b assets) may not exceed 40% of a bank's total high quality liquid assets.

2.7 The Basel III Liquidity Regime: The Net Stable Funding Ratio (NSFR)

The NSFR test considers the robustness of a bank's funding position (based on the bank's assets/activities) over a one-year period. It is assumed that the bank is then subject to an institution-specific stress of which there is public awareness and which results in:

- a significant decline in profitability or solvency as a result of increased credit, market, operation or other risk;
- a potential downgrade in debt; counterparty credit or deposit rating by any nationally recognised organisation; and/or
- a material event which calls into the question the reputation/credit quality of the Bank.

The NSFR is meant to eliminate funding mismatches between a bank's assets and liabilities by establishing a minimum acceptable amount of stable funding based on the liquidity characteristics of a firm's assets and activities over a one-year horizon. Implementation of the NSFR is scheduled for January 2018, with final revisions to be made by 2016. Until that point, the Basel Committee will observe the impact of the ratio and make changes if necessary.

The NSFR is defined as the available amount of stable funding divided by the required amount of stable funding. A minimum of 100% is obligatory under the rules.

$$\text{NSFR} = \frac{\text{Available amount of Stable Funding (ASF)}}{\text{Required Amount of Stable Funding (RSF)}} > 100\%$$

The amount of required stable funding (RSF) is measured using supervisory assumptions on the broad characteristics of the liquidity risk profiles of a firm's assets and off–balance-sheet exposures. A certain RSF factor is assigned to each asset type, with those assets deemed to be more liquid receiving a lower RSF factor and therefore requiring less stable funding.

Thus, for example, it is proposed that:

i. highly rated unencumbered marketable securities issued by sovereigns, central banks, and certain other highly rated institutions, with maturities of greater than one year and for which deep/active repo markets exist, will require Stable Funding equal to 5 percent of their value.

ii. highly rated unencumbered corporate and covered bonds require Stable Funding equal to 20 percent of their value
iii. holdings in gold will require Stable Funding equal to 50 percent of their value.
iv. unencumbered loans to retail customers and small businesses with less than a year to maturity attract an RSF factor of 85 percent.
v. off balance sheet commitments are allocated a RSF Factor of 65 percent.
vi. instruments and securities and loans to financial institutions with maturities of less than one year will require no Stable Funding to support them.

The aggregate RSF for a bank is simply calculated as the aggregate of each asset and off balance sheet item multiplied by the RSF Factor relevant to it.

Stable Funding is described as those types and amounts of equity and debt financing which are expected to be reliable sources of funds over a one year period of stress, that is:

i. capital;
ii. preferred stock (with maturity equal to or greater than one year);
iii. liabilities with maturity equal to or greater that one year;
iv. that portion of stable deposits which a bank is expected to retain notwithstanding suffering an extended period of idiosyncratic stress; and
v. the portion of wholesale funding with maturities (inc. of less than a year) that is expected to stay with the institution for an extended period in an idiosyncratic stress event.

The ASF is calculated as follows: The carrying value of all equity and liabilities referred to in (i) to (v) above are assigned to one of 5 categories, each of which categories has a percentage multiplier ("ASF Factor") allocated to it (the ASF Factor is intended to reflect the availability and quality of the Stable Funding type for these purposes). The ASF Factors from the Basel Liquidity Paper are:

i. 100% – capital (Tier1 plus Tier 2) as well as any funding with one year or longer maturity
ii. 90% – stable retail and SME deposits
iii. 80% – less stable retail and SME deposits
iv. 50% – less than one year corporate and public sector deposits
v. 0% – other less than one year deposits.

2.8 The Basel III Liquidity Regime: The Treatment of *Shari'ah*-Compliant Banks

The Group of Governors and Heads of Supervision of the Basel Committee (GHOS) in January 2013 stated that the GHOS recognizes that:

> Shari'ah *compliant banks face a religious prohibition on holding certain types of assets, such as interest-bearing debt securities. Even in jurisdictions that have a sufficient supply of HQLA, an insurmountable impediment to the ability of* Shari'ah *compliant banks to meet the LCR requirement may still exist. In such cases, national supervisors in jurisdictions in which* Shari'ah *compliant banks operate have the discretion to define* Shari'ah *compliant financial products (such as Sukuk) as alternative HQLA applicable to such banks only, subject to such conditions or haircuts that the supervisors may require. It should be noted that the intention of this treatment is not to allow* Shari'ah *compliant banks to hold fewer HQLA. The minimum LCR standard, calculated based on alternative HQLA (post-haircut) recognised as HQLA for these banks, should not be lower than the minimum LCR standard applicable to other banks in the jurisdiction concerned. National supervisors applying such treatment for* Shari'ah *compliant banks should comply with supervisory monitoring and disclosure obligations.*

These supervisory and disclosure obligations include:

- A clearly documented supervisory framework
- A disclosure framework

This recognition of *Shari'ah* banks compliance issues is very welcome and is an important step towards incorporating *Shari'ah* banks into the Basel regulatory framework. It is, however, not sufficient for *Shari'ah* banks to be fully compliant with many jurisdictions liquidity frameworks. It is to be hoped therefore that the following statement by the GHOS also points to central banks eventually allowing *Shari'ah* compliant central banks' deposits.

> *The GHOS also agreed that, since deposits with central banks are the most—indeed, in some cases, the only—reliable form of liquidity, the interaction between the LCR and the provision of central bank facilities is critically important. The Committee will therefore continue to work on this issue over the next year.*

2.9 The Impact of Basel III Implementation

As previously stated, one of the main features of Basel III consists of raising the quality and quantity of capital that banks hold against their risk weighted assets. Under Basel III, the capital requirements are established according to Exhibit 2.1.

The table shows that Basel III relies heavily upon the bank having equity capital, which must include a minimum of 4.5 percent which can be supplemented by other capital that can absorb losses without the bank being put into liquidation ("going concern" capital) of 1.5 percent (some forms of contingent convertible capital) and other capital ("gone concern" capital such as subordinated debt in the case of bankruptcy) of a further 2 percent.

As banks should not run at their regulatory minimum of capital, a further 2.5 percent equity buffer should also be added to the capital requirement. This buffer may be used, but only with the agreement of the applicable regulatory authority and subject to constraints, including restrictions on the bank's distribution of dividends to shareholders and payments of bonuses to staff.

A number of regulatory authorities believe that banks' capital requirements should be counter-cyclical (i.e., that banks should build up capital in good economic times in order to provide an additional buffer should the economy deteriorate). A buffer system was in place in Spain under Basel I and II and did prove useful as the economy deteriorated, since Spanish banks by and large had higher capital ratios than those of other comparable countries. The range of additional counter-cyclical capital has been set at 0 percent to 2.5 percent to allow individual regulators to use their discretion in this regard.

Certain financial institutions have been agreed to be either so large and so interconnected (or both) with the global financial system that any problems with them would cause systemic problems. These institutions are known as Globally Significant Financial Institutions (GSFI). These institutions should also hold an additional 2.5 percent of equity.

EXHIBIT 2.1 Basel III Capital Requirements

	Common Equity (after deductions)	Tier 1 Capital	Total Capital
Minimum	4.5%	6.0%	8.0%
Conservation Buffer	2.5%	2.5%	2.5%
Minimum plus Conservation Buffer	7.0%	8.5%	10.5%
Countercyclical Buffer Range	0%–2.5%		
Add on for GSFI*	2.5%		

*GSFI are Globally Significant Financial Institutions.

It is possible therefore for the biggest and most important banks to have a Basel III–based equity requirement of up to 12 percent and total capital of 15.5 percent.

2.10 Timeline

The significant changes required by Basel III will take time to implement, and thus many of the capital and liquidity targets set by Basel III will be implemented over time in accordance with the schedule in Exhibit 2.2.

2.11 Stress Testing

Another significant change with Basel III is a greatly increased emphasis on looking at so-called tail risks (e.g., risks with an apparently low probability but a high impact). The understanding of tail risk is especially challenging (see Section 4) and all banks' risk models must now incorporate regulators' stress scenarios.

As a result of the changes from Basel II to Basel III, the total capital held by many banks is likely to rise by between four and seven times. Those with large trading books will be especially affected.

3. THE IMPLEMENTATION ENVIRONMENT (SETTING UP A RISK MANAGEMENT FRAMEWORK IN A BANK)

Enterprise risk management (ERM) may be defined as a process for managing risk on a firm-wide basis, across types of risk, locations, and business lines. It is an increasingly important template which banks are encouraged by their regulators to use, to implement risk management under Basel II and III regulatory regimes.

There is nothing fundamentally original in the concept of enterprise risk management. Companies and especially banks have been managing their balance sheet risks on a top-down enterprise-wide basis for at least three decades. What is new is that companies now have tools that in many markets enable them to manage their balance sheet risks on a more integrated basis.

These are:

- Risk analytics—which provide a greater ability to understand not only the risk of any one transaction, but the risk of that transaction in the context of all other transactions the company is undertaking. Thus companies can now manage risk to some considerable extent at the portfolio level.

EXHIBIT 2.2 Phase-In Arrangements

(Shading indicates transition periods—all dates are as of 1 January)									
	2011	2012	2013	2014	2015	2016	2017	2018	As of 1 January 2019
Leverage Ratio	Supervisory monitoring		Parallel run 1 Jan 2013–1 Jan 2017 Disclosure starts 1 Jan 2015					Migration to Pillar 1	
Minimum common equity capital ratio			3.5%	4.0%	4.5%	4.5%	4.5%	4.5%	4.5%
Capital conservation buffer						0.625%	1.25%	1.875%	2.50%
Minimum common equity plus capital conservation buffer			3.5%	4.0%	4.5%	5.125%	5.75%	6.375%	7.0%
Phase-in of deductions from CET 1 (including amounts exceeding the limit for DTAs, MSRs and financials)				20%	40%	60%	80%	100%	100%
Minimum Tier 1 capital			4.5%	5.5%	6.0%	6.0%	6.0%	6.0%	6.0%
Minimum Total capital			8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%
Minimum total capital plus conservation buffer			8.0%	8.0%	8.0%	8.625%	9.25%	9.875%	10.5%
Capital instruments that no longer qualify as noncore Tier 1 capital or Tier 2 capital			Phased out over 10-year horizon beginning 2013						
Liquidity coverage ratio	Observation period begins					Introduce minimum standard			
Net stable funding ratio	Observation period begins							Introduce minimum standard	

Source: Bank for International Settlements (BIS).

- Risk management products—which allow a company to manage its credit or market risk exposures (e.g., credit default swaps, commodity swaps and options, and interest rate and currency swaps and options. There are also insurance contracts and outsourcing contractors available that make operational risk more manageable than in the past.

The availability of enhanced analytical tools and risk management products has in turn led to new governance structures.

There is no single risk governance structure that can be considered "correct." The availability of appropriate risk management analytics, data, products, and expertise should all play a role in defining the appropriate risk governance structure for any bank.

The key objective for any bank is to have a clearly defined and well-executed risk governance structure that allows it to understand and manage its risks. Trying to build a sophisticated ERM-based structure without the products necessary to manage the risks in an integrated manner is likely to prove frustrating. Such a structure may be less effective than simply having a risk committee with a broad membership.

Even in major international banks, many senior managers are rightly concerned that ERM-based analysis can become too sophisticated. Within the banking sector, risk management functions initially came into existence purely as control functions. Recently, however, there has been a trend towards a greater use of ERM in banks.

The definition, interpretation, and implementation of ERM vary from bank to bank, but within any bank's ERM framework it will usually be possible to identify two fundamental components.

The first component of a bank's ERM framework is a clearly defined and well-established management oversight of the control culture (the first element in the Basel Committee internal control framework), which includes some or all of the following features:

- The board and senior management articulate a risk management and control philosophy that sets the tone for the risk management culture throughout the bank.
- The risk appetite of the institution is set by the board and senior management.
- Risk is defined to include all of the risks faced by the bank—both financial and nonfinancial, and both internal and external.
- Risks are considered on a portfolio basis—across risk types and across business entities.
- Risk considerations are an integral component of strategy formulation and implementation. Risk considerations are also an integral component

of day-to-day activities. ERM involves all personnel at every level, from the board downwards.

The second component of the ERM framework is a risk management process that corresponds to the four remaining elements of the risk management framework. The terminology used to describe the risk process varies from company to company but will in general cover:

- Risk recognition and assessment.
- Control activities and segregation of duties.
- Information and communication.
- Monitoring activities and correcting deficiencies.

Internal audit performs an important role in monitoring ERM. In annual reports, this role is usually described separately from the risk management process—perhaps reflecting and emphasising the independence of the internal audit function.

3.1 Models for the Grading of Credits and Establishing a Credit VaR

As described earlier, individual grading models fall into three main categories, reflecting the work of three famous academics:

1. Credit scoring models—Edward I. Altman.
2. Option-theoretic models—Robert C. Merton.
3. Reduced form (empirical) models—Robert A. Jarrow.

Credit Scoring Models Credit scoring models are based on financial accounting ratios. They come in two main types:

1. Univariate models.
2. Multivariate models.

Univariate Models Credit analysis of potential borrowers has a very long history; anyone particularly interested in this topic should read *The First Crash* by Richard Dale, published by Princeton University Press, for an excellent description of the financial analysis done by Archibald Hutcheson on the South Sea Company in 1720. It is the earliest documented, substantive, financial ratio analysis we know of.

Hutcheson used financial ratios, combining accounting information and market price information, to judge the value of an investment (in equity

and debt) and the likelihood of those investments defaulting. What he did was to look at a range of different financial ratios of the debt to equity and of the cash flow of the company and make a judgement call on what the financial performance of the company was likely to be in the future.

This form of model is known as a univariate model. The resulting "grade" is based on case-by-case judgement; the contribution of each piece of the analysis to the resulting probability of default (PD) or PD/LGD (loss given default) is not disclosed. Indeed, it may not be known, as it may vary based on the individual's experience.

Such models are still in widespread use today, as any equity broker's report will evidence, and are very commonly used by banks, especially to make judgement calls on lending to private companies—typically to so-called small and medium enterprises (SME)—but also in personal lending and even in lending to public companies.

Such models are of course very flexible, but this can also be a weakness as the model results (the decision to lend and at what price) are essentially dependent on an individual's judgement (or typically the collective call of a credit committee for loans above a certain figure).

Multivariate Models In many banks, models based on Altman's techniques dominate their loan grading and pricing functions. In particular where credit assessment is more centralised it is common for the bank to use a multivariate rather than a univariate version of these models.

Multivariate models identify financial variables that have statistical explanatory power in differentiating defaulting firms from non-defaulting firms. It should be noted, however, that each version of the model may only be applied to a specific industry or industry within a country-specific context.

The fixed weights given to each variable, which are applied across all applications of the model, may be assessed based on judgement but are more commonly assessed by use of statistical analysis of the most powerful explanatory variables. These models allow the creation of a "score" for each credit which can be converted into a PD.

Financial ratios measuring profitability, leverage, and liquidity are the most commonly used variables.

Whilst such models prove to be useful in practice, there is little economic theory to back the choice of any particular financial ratio in forecasting default.

Expert Systems Banks have made attempts to embed greater discipline in the results from such models, by using review processes and in some cases by developing "expert systems." In these, the judgement is formalised as far as possible by the use of ordinal grading (e.g., excellent, good, fair, poor) and a

combination of judgemental factors (management expertise, depth of management, speed to market, etc.) as well as categories of financial performance (gearing/leverage, earnings, collateral) and macroeconomic factors (cyclicality, sensitivity to interest rates, etc.), which are combined and the resulting "grades" compared to historic default data.

Most banks will also instigate annual review processes to coincide with the release of new audited financial data. This may result in a regrading of the company's debt. There may in practice be little the bank can do to reprice the debt or change its payment schedule, as banks often lend for periods far in excess of one year. As we shall see, however, the ability of any model to accurately grade debt over periods in excess of one year is limited. John Maynard Keynes's aphorism, "the future is not unknown, it is unknowable" is true, and in a real sense the future is more unknowable the further into it we try to look, in that the range of possible outcomes gets larger.

The number of factors considered by these models also can be very large. The number of factors in one such model is over 300, though most research on such models suggests their predictive power is increased only slightly by additional factors once the number of these exceeds low double digits.

Neural Networks When using large numbers of explanatory variables, these models will usually be built using some form of neural network to "train" the system so that the computer system will devise weights for each explanatory variable based on the best fit of the weights to past downgrade and/or default data. This is, however, an exercise in the application of statistical method, and the resultant weights may not have an economic interpretation. It is also important to test such models against "out-of-sample" data, that is, to ensure that the model accurately predicts default and does not "over-fit" the data by not only predicting accurately defaults that do happen but also predicting large numbers of defaults that do not happen (false positives). This may happen because typically the number of non-defaulting firms considerably exceeds the number of defaulters and the latter may be over-represented in the data used in the model.

Merton Models Merton modelled equity in a leveraged firm as a call option on the firm's assets.

The concept behind the model was that if at expiration of the option (usually modelled over a one-year period) the market value of a firm's assets exceeds the value of its debt the firm's shareholders will exercise the option to "repurchase" the company's assets by repaying the debt (or refinancing it), whereas if the opposite were true the shareholders would default on their debt, allowing the lenders to take control of the firm's assets.

The distance to default (DD) is defined in the model as the number of standard deviations between current asset values and the debt repayment amount.

The higher the distance to default the lower the probability of default (PD).

In this model the PD over a one-year horizon is equal to the likelihood that the option will expire out of the money.

To convert a DD to a PD, Merton assumed asset values were lognormally distributed.

This differs from the commercially available KMV models, which estimate the empirical PD using historic default experience.

Historic evidence shows a firm with a DD equal to 4 has an average historical default rate of 1 percent.

Jarrow Models Known as reduced form or intensity-based models, Jarrow models view default as a sudden unexpected event (consistent with empirical observations). Defaults occur randomly with a probability determined by the intensity or "hazard" function.

These models use observable risky debt prices in order to ascertain the stochastic jump process governing default.

Credit spread can be viewed as a measure of the expected cost of default ($CS = PD \times LGD$).

Using one or any combination of the models above, once the probability for default for each asset can be computed, then each loan in the portfolio can be valued (often done by using Monte Carlo simulation), which produces a probability distribution of portfolio values. A loss distribution can then be calculated permitting the computation of value at risk (VaR) measures of unexpected loss.

3.2 Connections between Risk Categories

Many banks may start the process of ERM by looking at the way in which some of their businesses or products exhibit strong connections between risk categories, such as commodity market risk and credit risk. Such connections are common; for instance, market risk inevitably brings with it counterparty credit risk.

An understanding of the correlations between different risks within a portfolio, between portfolios and between different risks categories can be a powerful tool for reducing the total amount of risk born by any business.

It is important to recognise that correlations are observations; they do not necessarily imply cause and effect. Moreover, correlations in financial markets in particular are in general conditional—the relationships change depending on where the economy is in its cycle. Such correlations are also dynamic in that they change as a result of potential drivers such as technology or even participants' behaviour, which can occur with the development of new products or markets.

It is therefore important to maintain a certain wariness in relying on observed or assumed correlations within, let alone across, risk categories.

It is also important to note that this "netting" through correlation between risks as described above occurs after individual risks have been netted to achieve the lowest possible individual risk within each risk category. In this context, much is currently being made of the risk reduction that can occur through the netting of the credit counterparty risk that can be done by moving over the counter (OTC) derivative contracts to exchanges to become exchange traded contracts. This does bring some welcome benefits through standardisation of contracts, better disclosure of market participants business volumes, and overall risk exposures but also concentrates counterparty risk in the exchange itself, which becomes the credit counterparty to every transaction. Ensuring exchanges have appropriate risk control and capital thus becomes a greater issue to regulators and market participants as well as the exchanges owners.

Whilst many concepts in ERM have their origins in portfolio management, it is important not to get carried away with this idea. While any grouping of risks may be characterised as a portfolio, they are as likely as not to be more of a collection of disparate risks acquired, not as a result of deliberate choice, but as an inevitable result the of conducting a business over a number of years.

3.3 Economic Capital

Some companies (notably banks) have developed economic capital frameworks as tools for assessing risk, and have realised benefits in the following areas:

- Risk management—economic capital provides a consistent and comprehensive risk management tool using a common language and measure.
- Capital adequacy—economic capital calculations can be used to determine the level of capital needed to absorb severe losses.
- Risk appetite—the amount of risk that a company is willing and able to take. Economic capital is often used to explain risk appetite as it is linked to the cost of risk (see below).
- Strategic planning—economic capital can be used to take into account the cost of risk when planning future strategy, by making it clearer which alternatives create the most value. It can also be used when assessing the success of existing strategies.
- Performance assessment—economic capital can be used in performance assessment, by evaluating the returns in relation to risk (risk adjusted rate of return).

- Portfolio and product management—economic capital can be used to support decisions in many operational contexts.

Economic capital is the amount of capital required to absorb severe unexpected losses over a specified period with a specified confidence level.

Economic capital is often depicted using charts such as the one shown in Exhibit 2.3. The chart shows the typical distribution of a bank's losses, with the size of loss indicated on the X axis and the frequency of loss indicated on the Y axis. The shape of the chart indicates that losses will usually be less than the expected (mean) loss, but that occasionally there will be very large losses.

Expected loss is the anticipated average loss over a defined period of time. Income to offset these losses would normally be factored into product pricing. For example, product margins should cover expected credit losses as well as overhead costs and the cost of unhedged risk.

Unexpected loss is the potential for actual loss to exceed the expected loss, which reflects the inherent uncertainty in the loss estimate. Capital is held to absorb unexpected losses, and the cost of holding such capital should be factored into pricing decisions

The confidence level (or level of certainty) indicates the probability that the economic capital will be sufficient to absorb unexpected losses over a specified time period. It is sometimes interpreted as the risk of insolvency during the specified time period

Tail risk is the potential for actual loss to exceed the estimated unexpected loss according to the right-hand tail of the assumed statistical distribution (the so-called fat tail problem). Capital is held to absorb these extreme losses (losses beyond estimated unexpected loss), and the cost of holding such capital should be factored into pricing decisions.

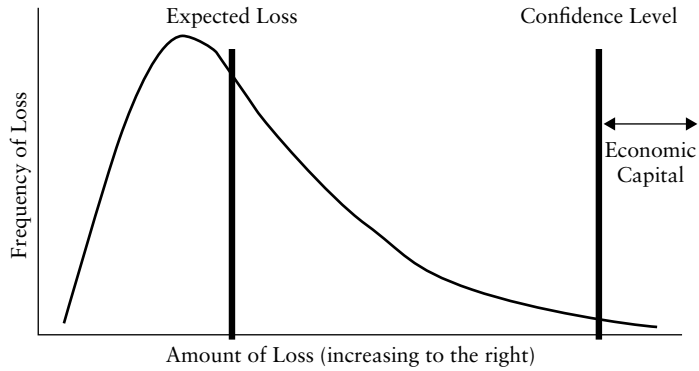


EXHIBIT 2.3 Loss Distribution Illustrating Economic Capital Concept

Economic capital models invariably incorporate correlations in their computation of the total amount of capital required by a bank to support its risks, and the way these calculations operate also invariably reduces the total capital the bank requires to support a given level and structure of business, when compared to a less sophisticated approach to risk management where all risks are simply additive with no (or very limited) allowance for one risk to offset another. It should be noted, however, that these models do not usually incorporate any allowance for "dynamic conditional correlation" between risks, which may significantly increase the contribution of correlations to total risk due to some extreme (usually market wide) event (see Section 4).

4. THE FUTURE RISK ENVIRONMENT

Financial crises have been the main driver in the development of the information systems and financial products necessary to undertake risk management.

Whilst these crises have often originated in financial markets, the lessons have been drawn on by governments, regulators, auditors, and analysts, and have changed perceived "best practice" in corporate governance and risk management.

The continuing crisis from 2007 onwards has brought attention to the dynamic and conditional nature of correlations, and as a result, to the way in which risks that appear to offset one another can in extreme market circumstances reinforce one another. Tail risk can consequently increase as a tail event (crisis) progresses, producing a growing need for capital to support losses as a crisis develops.

Exhibit 2.4 shows such an extreme value distribution (with a fat tail) and can be contrasted with Exhibit 2.5, which shows the type of distribution that results from the application of portfolio-based risk and capital models incorporating dynamic conditional correlation.

Basel III significantly shifts the emphasis in modelling risk from a simple VaR approach, based on mean variance analysis, to the greater use of stress tests to establish the effect of tail risk (low frequency, high impact, i.e., very unlikely but bad, outcomes) on the bank.

Stress tests form an integral part of internal risk management practices under Pillar 2 and of regulatory requirements, as imposed in the context of the advanced models under Pillar 1, most obviously because Basel III weights trading book transactions in relation to their "Stress VaR."

The results of the bank undertaking stress tests are documented in particular via the ICAAP and ILAS report, which the bank management submits to the board of directors, and subsequent to the board's approval

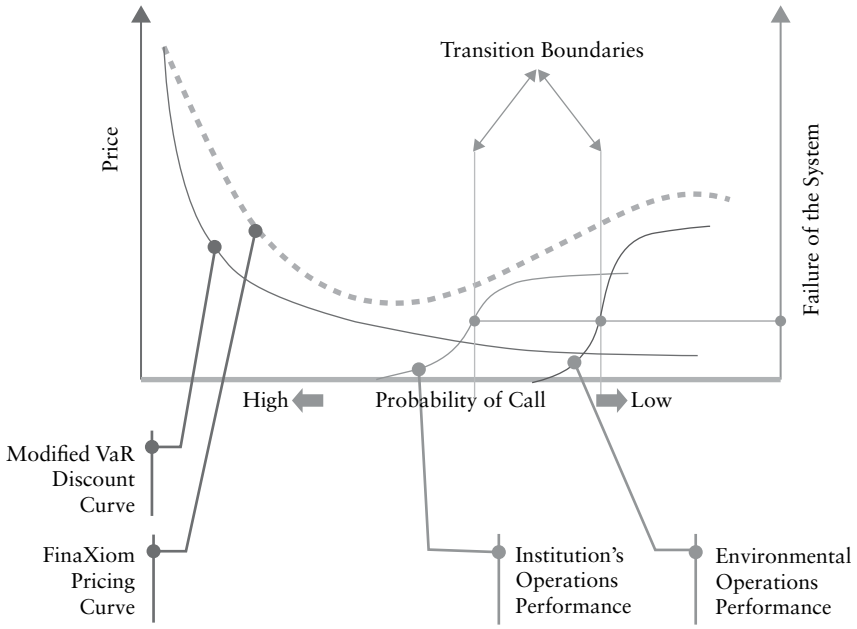


EXHIBIT 2.4 Distribution 1

these are sent to the bank's regulator. The stress tests used by the bank will require the approval of the regulator, and in most instances it is likely that the regulator will require banks to submit at least one scenario as laid down by the regulator. An example of this is the way EU regulators have required banks within the European Union to undertake stress tests related, *inter alia*, to common assumptions on their provisioning against certain EU states' government bonds.

It is especially important to ensure engagement of the board of directors in the stress testing of the bank, as most regulatory authorities are likely to have greater engagement with bank boards under Basel III to ensure the board understands the implications of the risks the bank runs, the possible effects of stress market events on the bank's capital and liquidity, and the implications for its business model. Whilst a valid criticism of Basel III is that it does not directly connect in its reporting structures the ICAAP and ILAS, let alone the bank's business model and the bank's financial performance, it is likely that many bank boards will require these connections to be made to aid their own understanding.

The Exhibit 2.6 shows an integrated process in which the documentation of the board's strategy and the bank's business model is reflected in an anticipated budget outturn over the next year and following two years of

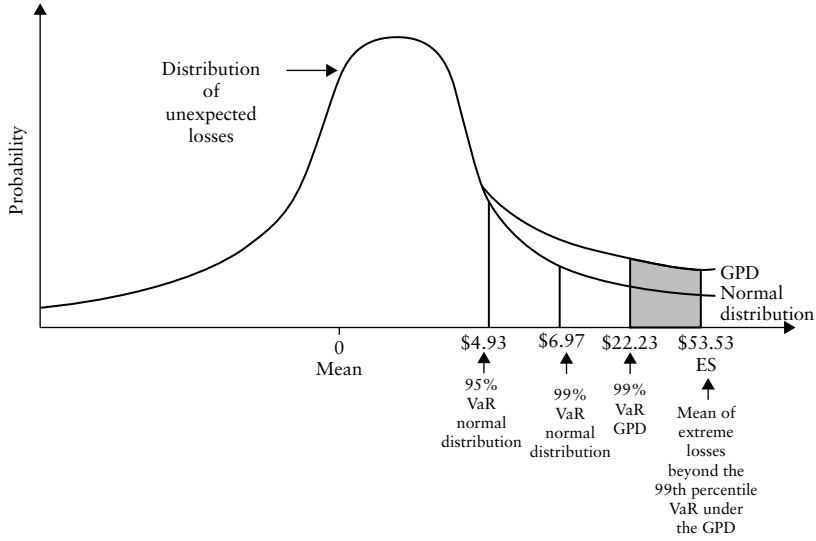


EXHIBIT 2.5 Distribution 2

*GPD stands for Generalised Pareto Distribution. It is one of many distributions that can be used to describe data that exhibits "Fat Tailed" characteristics—a very common feature of price movements in financial markets.

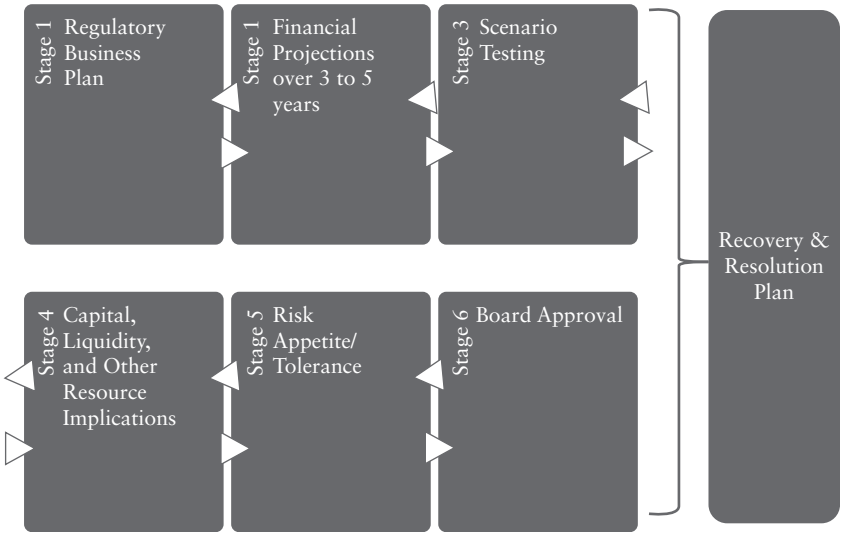

Stage 1 Regulatory Business Plan
Stage 1 Financial Projections over 3 to 5 years
Stage 3 Scenario Testing
Recovery & Resolution Plan
Stage 4 Capital, Liquidity, and Other Resource Implications
Stage 5 Risk Appetite/ Tolerance
Stage 6 Board Approval

EXHIBIT 2.6 The Board Process

financial forecasts, the budget/forecast is reflected in capital and liquidity requirements, and then the whole is subject to a series of stress tests to establish the robustness of the projected financial outturn, including capital and liquidity requirements. This form of integrated financial performance reporting has proved very successful in bringing together the board's strategic outlook and the regulator's requirements for an enhanced understanding of risk at board level.

Stress tests come in two distinct forms, being based either on sensitivity analysis or on complex scenarios. The former would (for example) encompass the bank's sensitivity to adverse changes in interest rates, or perhaps to exchange rates, or to downgrades of certain credits or defaults of certain counterparties. They are useful in seeing what specific risks the bank is concentrated in.

Scenarios are attempts to hypothesise a set of events which may adversely affect the bank; an obvious one for a bank with exposure to European markets might be what would happen if the euro area was dissolved or if a certain country left the euro area and reintroduced its own currency.

The importance of a robust programme of stress testing under Basel III cannot be overemphasised, and these stress tests must include what is known as a reverse stress test, which is effectively a stress test to destruction (i.e., to a point where the bank fails to meet its regulatory minimum standards for capital and/or liquidity). The purpose of this test is to identify the causes and consequences that could lead to that outcome.

This reverse stress test is itself, therefore, a basis for regulators to use their powers to require systemically important banks to prepare recovery and resolution plans (often called "living wills") to ensure that if the bank fails it can be liquidated with the least possible disruption to financial markets and to other banks.

Because stress tests specifically address the effect of extreme events on banks, they can result in the appearance of risk concentrations within a bank's business that it may not have been aware of. The importance of this is illustrated in Exhibit 2.4, where we see that the dotted line shows a distribution of outturns where very bad results become, past some point, more likely but not less. These so-called extreme value distributions are well known in the insurance business, but have until now not been a common feature in banking. It is, however, not hard to give an example of how such risk distributions can be produced for the banking industry.

Let us suppose you are running a bond desk at an investment bank and that you trade and make a market in both government and corporate bonds. The economy deteriorates and the corporate bonds begin to fall in value as the risk of default is increasing; correspondingly, risk-averse investors buy

more government bonds and the value of these bonds rises as investors seek a lower risk investment. Your risk model has corporate and government bonds negatively correlated to each other, which is what you expect to happen. However, the economy deteriorates very rapidly, you can no longer sell your book of corporate bonds, and raising money by offering them as security is very costly, as the funding banks require very large and growing (as the economy deteriorates) "haircuts" on their value. You must fund your book, so you start to sell the government bonds, but you are one of many, and the government bonds now start to fall in price. Note that your risk model is now wrong, as the correlation between the price movements of government and corporate bonds has now turned positive. What was a hedged book has become a very large risk concentration of the bank.

System-wide risk modelling is in its infancy, but it is likely to be one of the major areas of research, policy development, and strategy and product innovation as banks, regulators, and central banks focus on systemic risk.

5. ISLAMIC BANKS AND THE RISK AND REGULATION ENVIRONMENT

Islamic banks and financial markets have been affected by the international financial crisis, but, according to a recent IMF study, they have proven more resilient and less unstable than their conventional competitors.

This means they are also well placed to take advantage of any economic upturn, particularly as the Basel III reforms highlight not only structural weaknesses in conventional banks and financial markets but also the strengths of Islamic finance.

The reforms will also put the two systems of banking on more equal terms in the two critical areas of liquidity and capital structures. However, to take full advantage of these opportunities, the Islamic sector will also have to take other measures, including the development of standardised international products through organisations such as the recently established International Islamic Liquidity Management Corporation (IILM).

5.1 Capital

The Basel III reforms will have a major impact on capital structure by making conventional banks change from a system dominated by equity and more especially debt capital to one in which equity, supported by contingent capital, is the most important element.

At present, Islamic banks are at a competitive disadvantage: Their capital structures are of necessity dominated by equity because they cannot

use debt capital, which (when interest expense is tax-deductible) has a materially lower cost than the equity capital. Consequently a conventional bank will offer equity investors a significantly higher return than an Islamic financial institution with a similar balance sheet (and therefore similar total risk). This advantage will be substantially reduced by Basel III, because it will force conventional banks to hold much more equity.

The greater emphasis on contingent capital, a new and not well-understood concept, will also benefit Islamic banks. The few contingent capital structures issued so far are dominated by a form of convertible bond (often called CoCos), where the convertibility "option" is not exercised at the discretion of the bond holder but is mandatory based upon "triggers," such as a fall in the bank's equity-to-asset ratio and/or supervisory intervention in the management of the bank.

Clearly the "bond" nature of the CoCos makes them unsuitable for Islamic banks. But contingent capital, as a concept and product, can trace its origins to the insurance industry and specifically to structures that are based on those of an "indemnity fund." These can be made *Shariah*-compliant relatively easily.

Such structures, very competitive on cost, feature terms similar to CoCos and hold out the very real prospect of helping to equalise the capital structures of Islamic and conventional financial institutions, thereby making Islamic banks relatively far more attractive to investors by levelling the returns to capital.

5.2 Liquidity

The balance between the conventional and Islamic sectors is also changed by the changes in liquidity demanded by Basel III.

At present, banks have access to funding liquidity based on the bank's funding structure. If the bank has plenty of stable retail deposits and medium- to long-term funding through bonds, certificates of deposit, or profit and loss sharing accounts, for example, the bank can use these stable sources to fund its asset base, even in difficult economic circumstances. Islamic banks are by and large well-funded institutions, though with very limited capability to transfer their liquidity across national frontiers. This limits their capacity to create rivals to conventional international banks.

Liquidity can also be raised in the market, as a bank can turn its assets into cash either by selling them or by pledging them in order to borrow funds. Market liquidity has grown substantially in recent years, largely due to the growth of so-called repo (repurchase) transactions where banks can pledge assets so they can receive funds.

Conventional banks have been able to take advantage of this market's growth to fund new business in areas where they have been less able to

attract retail deposits or issue debt securities. In contrast, *Shari'ah*-compliant asset products lack this degree of standardisation, sometimes even within national boundaries, and where national markets have developed they have not been able to support international growth.

To address this problem it is necessary to create international product structures which will lead to the creation of common product features and legal contracts on which asset transfers can be based.

In doing so, however, it should be remembered that the short term nature of repo markets did make them a potentially unstable source of funding—in the recent financial crisis, lenders became unsure of the capability of the underlying assets to be a secure source of repayment for the loans. It should be possible for the Islamic sector to avoid this problem, as transparency and reference to assets with readily observable cash flows are both features of *Shari'ah*-compliant assets.

While these liquidity and capital requirements under Basel III will benefit the Islamic financial sector, there are nonetheless challenges to be addressed.

The emphasis of some Islamic banks on profit- and loss-sharing (PLS) accounts as a secure source of funding must be qualified. The opaque nature of the "smoothing reserves" held against these accounts is likely to be problematic for bank regulators—who in many countries have fought a long battle to eliminate so-called reserve accounting in the banking industry, which they say is used to smooth reported profits—as well as for accountants, because the International Financial Reporting Standards (IFRS), as implemented, makes it virtually impossible to maintain reserve accounting, at least unless its effects on profits are made completely transparent (in which case it may not serve the banks' purpose).

These factors may make PLS deposits less attractive to Islamic banks unless steps are taken to reform their structure so as to maintain the stability of their payouts without incurring adverse treatment from regulators and accountants. The reliance on retail funding also tends to lock Islamic banks into their domestic economy. The lack of standardised products internationally, and the often very specific national regulation of Islamic banks, mean that the often-quoted $1 trillion of *Shari'ah*-compliant "liquidity" globally is something of a myth. In practice, the liquidity is locked into individual national "pools" and there is only a limited capability to move surplus liquidity to countries that may have investment potential but a shortage of funds.

Basel III also stresses the need for banks to maintain a stock of assets that can easily be turned into cash at reliable values either through markets or, should such markets cease to function, through central bank cash from a "discount window."

The governments of a number of states where Islamic banks are based do issue *sukuk*, which can provide assets that qualify for discount window

access, but a number of countries important to international banks, including the United States and the European Union member states, do not do so.

While these countries will accept as bank stock liquidity some assets issued by AAA-graded countries and a limited number of international institutions (this is complicated in the case of the EU countries by obligations under EU treaties), there is, even so, virtually no *sukuk* issuance that meets the needs of international banks. The exception is the *sukuk* issues by the Islamic Development Bank (IDB), which meet the stock liquidity requirements of the UK Financial Services Authority (UK FSA). However, these issues are not very liquid, as banks and investors tend to hold them to maturity.

To address this gap in the market, it is necessary to have liquid AAA-rated government *sukuk* issued across a range of maturities. This will provide stock liquidity to international Islamic banks (and to domestic banks in countries where there are no government *sukuk*). And crucially, it will also help create a zero-credit-risk profit rate curve (i.e., a profit rate curve showing different rates for different tenors of funds). Zero (credit) risk yield curves allow conventional banks to price their own credit and that of their customers of differing credit risk quality, by reference to such a curve.

Today, the lack of an equivalent to assess the credit standing of those entities to which Islamic banks advance funds creates problems of pricing credit risk for Islamic banks; and when this is combined with generally illiquid *Shari'ah*-compliant product markets, the result is that sovereign and corporate *sukuk* issues trade at what often appear to be illogical prices in relation to their relative credit standing.

Rather than wait for the liquid AAA sovereign *sukuk* market to happen, there are initiatives that could be taken by those countries with a strong interest in developing *Shari'ah*-compliant banking and finance, including the development of a strong role for the IILM. Set up though the actions of Bank Negara's governor Tan Sri Dato' Dr. Zeti Akhtar Aziz and the IFSB's then-Secretary-General Professor Datuk Rifaat Ahmed Abdel Karim, IILM's initial membership of 13 includes, among others. Saudi Arabia, Qatar, Luxembourg, and the Islamic Development Bank.

The IILM's first objective is to issue *Shari'ah*-compliant financial instruments to facilitate more efficient and effective liquidity management for the Islamic banking industry, and initially will focus on issuing short-term paper in international reserve currencies. This will make a very important contribution to the resolving the problems caused by the separate "pools" of liquidity in *Shari'ah*-compliant markets.

There do not yet appear to be any concrete plans to build upon the concept of product standardisation and the credit quality assurance it creates. But it is possible to envisage that the standard product definition could

be created in a way that could at a later date allow the tenor of the product to be extended. Such a move could also make a potentially important contribution to the lack of the necessary stock liquidity instruments to support Basel III compliance by International Islamic Banks.

5.3 Trade Transactions as Liquidity?

The financing of trade in goods and services and the financing of investments in real assets dominates the provision of finance by Islamic banks. This is due in part to the nature of *Shari'ah*-compliant finance, which places the funding of transactions in the real economy at the centre of the banking system.

It is also due to the fact that Islamic banks primarily operate in emerging economies where the intermediation role of banks is primarily associated with the provision of capital to trade and industry. If we are to develop and apply global banking regulation to banking systems in both developed and emerging markets across both conventional and Islamic banks, regulation will need to accommodate radically different banking models based on the different roles banks perform within different economies.

Developed markets historically had many of the same characteristics as emerging market economies do today. Their banking systems were developed in support of the financing of trade and industry. Central banks developed their role both as regulator of individual banks within the system and in support of the financial stability of the banking system as a whole. There are a number of practical lessons that can be learned from looking at history. Liquidity, not capital, has historically been the main concern of central banks as regulators and supervisors of the banking system. Historically, banks have failed when they were not able to meet their obligations as and when they fall due.

Ever since the recognition by governments of the need to avoid the systemic risks associated with a bank collapse, the focus of regulatory and supervisory authorities has been on the provision of liquidity to both individual banks and to the banking system.

Basel II has often rightly been criticised for its concentration on bank capital and for subsequently paying little attention to bank liquidity and its management.

Basel III addresses this deficiency, as there is under Basel III an emphasis on the need for banks to maintain a stock of assets that can easily be turned into cash at reliable values through markets and, should such markets cease to function, through central bank cash provision by way of a discount window.

Islamic banks are not alone in having issues with the availability of suitable liquid assets. A number of regulators have working parties on the subject of "additional liquid assets treatment." Most prominently this

involves banks in Australia, the European Commission (on behalf of some non-Eurozone countries) and Hong Kong, where it is felt additional classes of liquid assets will be required.

As the liquidity provider of last resort, a central bank faces a very difficult dilemma if it provides funding liquidity to commercial banks against anything other than government liabilities, as in doing so it creates a potential credit risk for the central bank's shareholders (their government). Provision of liquidity against the collateral of government liabilities (treasury bills, government bonds, etc.), on the other hand is an easy decision from a credit perspective. A claim against the state is the same credit whether it is a 1 coin or a 1 share of a government bond. Providing 1 coin against the pledge of a mortgage loan from a commercial bank, for instance, is quite a different matter.

This thinking has led central banks and Basel down the path of allowing as "stock" liquidity domestic government bonds, though in the case of the European Union the provisions of the EU treaties have significantly complicated the issue of allowable stock liquidity, even to a point that EU government bonds are allowable across the euro area whatever the credit standing of some EU governments. This fixation with government bonds from a central bank credit perspective is understandable, but if we contrast government bonds with trade bills, the latter have a number of advantages:

- Trade bills are based on self-liquidating trade transactions. They are short term in nature (usually one to three months' tenor) and thus any commercial bank can easily generate liquidity, even if no rediscount is available, simply by allowing their stock to run off without undertaking new business.
- If rediscount of trade bills is available, then the bank has an incentive to maintain lending against commercial trade transactions, thus encouraging commerce, whereas if only government bonds are available for discount there is no incentive for banks, when their balance sheets are under stress, to maintain commercial lending.
- Central banks, in providing rediscount to trade bills, are taking only short-term credit risk, in contrast to various central bank emergency facilities that have had to involve assets such as longer term mortgage lending.
- In practice, when the Bank of England historically allowed certain (eligible) trade bills as liquidity, it was further distanced from the credit by insisting trade bills be accepted (guaranteed) by a second bank in addition to the originating bank and also by providing funds (by rediscounting the bills) to the discount houses that advanced funds to the commercial banks holding the bills; thus, the discount houses' capital also provided a "buffer."

- Many commercial banks naturally originate trade bills as a result of their lending to companies and are well acquainted with the credit involved.
- Trade bills typically pay a rate of interest above a commercial bank's cost of funds, in contrast to government bonds that pay a rate of interest significantly below a commercial bank's cost of funds.

It is important also to recognise that the use of trade bills as widely used liquid instruments had a very long history, lasting from the late eighteenth century until Basel I in 1988. They are still in use in Australia.

In the case of Islamic banks, whose access to suitable government bonds as stock liquidity instruments is restricted to only a few domiciles (such as Sudan, Malaysia, Indonesia, and some Gulf countries), there is a strong case for allowing suitably structured trade financing transactions as a form of liquidity provision. Fitting this within the Basel III liquidity regime, as proposed, would not be possible. There is no reason, however, why any central bank could not accept (for the banks it supervises) short-term trade-related instruments (including *Shari'ah*-compliant instruments) as eligible stock liquid instruments against the security of which the central bank could provide funding. Adapting Basel III to allow such trade financing transaction products should be possible, perhaps through the use of a covered bond–like structure.

The attraction of holding short-term assets when the issuers of bonds may be subject to changes in credit spreads are obvious, as the effect on valuations are much less.

Self-liquidating short-term transactions based on good commercial credits backed by bank credit support (acceptance/covered bond) look more attractive today compared to many long-term government bonds.

The Basel fixation against commercial credit risk may, however, remain a strong impediment to a structure too closely aligned to the old eligible trade bills product.

In this instance, the possible structures emanating from the International Islamic Liquidity Management Corp (IILM), including covered bond–like structures, may be important in creating the required product structures.

CHAPTER 3

Risk Characteristics of Islamic Products: Implications for Risk Measurement and Supervision

Venkataraman Sundararajan

1. INTRODUCTION

This chapter discusses risk characteristics of various Islamic finance products and key issues in the measurement and control of risks in Islamic financial services institutions. In particular, the chapter highlights the role of risk sharing in Islamic finance and the implications of profit-sharing investment accounts (PSIA, or "investment accounts") for risk measurement, risk management, capital adequacy, and supervision. Empirical evidence suggests that the sharing of risks with PSIA is fairly limited in practice, although, in principle, well-designed risk (and return) sharing arrangements with PSIA can serve as a powerful risk mitigant in Islamic finance. Supervisory authorities can provide strong incentives for effective and transparent risk sharing and for the associated product innovations. The chapter also covers the scope of supervisory intervention and a value-at-risk (VaR) methodology for measuring these risks.

A key principle underlying the design of Islamic financial products and services is the notion that mutual risk sharing (for example, between banks and entrepreneurs, or between banks and depositors) is a viable alternative to interest-based financing, which is prohibited in Islamic finance. Islamic financial products and Islamic banks face a unique mix of risks and risk-sharing arrangements that arise from the contractual design of instruments based on *Shari'ah* principles and the overall legal, governance, and liquidity infrastructure governing Islamic finance.

Islamic Finance: The New Regulatory Challenge.
Edited by Simon Archer and Rifaat Ahmed Abdel Karim
Copyright © 2013 by John Wiley & Sons Singapore Pte. Ltd.
ISBN: 978-1-118-62897-3

Effective risk management, however, requires appropriate risk measurement that recognises the specific mix of risk factors in Islamic financial contracts and the extent of risk sharing embedded in the contracts. The issues of risk measurement and disclosure are central to adapting the New Basel Capital Accord—*International Convergence of Capital Measurement and Capital Standards: A Revised Framework* (Basel II)—for both conventional and Islamic banks. The same may be said in connection with *Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems*, published in a revised version in June 2011, which places an emphasis on liquidity risk which was absent from Basel II.

Risk measurement is also crucial to an effective disclosure regime that can harness market forces to reinforce official supervision. The purpose of this chapter is to review the risk characteristics—defined as the type and mix of risks and the arrangements to share risks—of Islamic products and the related issues in the measurement of risks in Islamic banks. In particular, the chapter analyses the implications of profit-sharing investment accounts for risk measurement, risk management, capital adequacy, and supervision. Islamic banks in most countries offer two types of PSIA: restricted and unrestricted, normally based on a *mudarabah* contract. The bank as *mudarib* is entitled to a prespecified percentage share of the profits from the investment as a fee for fund management, but does not share in a loss except by not receiving any fee. There is thus, in principle, a considerable degree of risk sharing between the bank and the investment account holders (IAHs) with respect to the assets in which the PSIA are invested.

The restricted investment accounts are a type of collective investment scheme in which the bank as *mudarib* invests the funds of the IAH according to a restricted mandate that limits the asset allocation to a prespecified category of assets. The unrestricted investment accounts are designed as a *Shari'ah*-compliant alternative to conventional interest-bearing deposit accounts; the IAH funds are invested at the bank's unrestricted discretion and are normally commingled for investment purposes with other funds, such as the bank's own capital and current accounts. (Current accounts are a liability of the bank and do not share in profits.)

Available empirical evidence shows that in practice, because the product is intended to provide a *Shari'ah*-compliant alternative to conventional deposits, there is considerable smoothing of the profits paid out to unrestricted IAHs, and correspondingly reduced sharing of risk between the bank and the holders of such investment accounts, with banks in fact bearing the majority of the risk despite wide divergences in risk. The extent of this *de facto* departure from the risk-sharing principle for unrestricted IAHs (referred to as displaced commercial risk, or DCR, following AAOIFI 1999)

varies between countries; in some countries, banks are expected—though not legally bound[1]—to bear virtually all of the asset risk, while in others it is simply a matter of competitive pressure. References to IAHs, investment accounts, or PSIA in the remainder of this chapter should be understood as being to unrestricted IAHs.[2]

This chapter proposes a specific approach to the issue of DCR by measuring the actual sharing of risks between shareholders and IAHs, based on value-at-risk methodology. The two main conclusions of the chapter are as follows:

1. Appropriate management of PSIA, with proper measurement, control, and disclosure of the extent of risk sharing with IAHs, can be a powerful risk mitigant in Islamic finance.
2. Supervisory authorities can provide strong incentives for effective overall risk management, and transparent risk sharing with PSIA, by (a) linking the treatment for capital adequacy purposes of the share of assets on the bank's balance sheet that is financed by PSIA to a supervisory review of bank policies for risk sharing; and (b) mandating the disclosure of risks borne by PSIA and of the DCR borne by the shareholders as part of the requirements for deciding the amount of any capital charge to be applied to this share of assets—that is, the fraction of the PSIA share of risk-weighted assets that could be excluded from the denominator of the bank's capital adequacy ratio (CAR). The evolving standards for capital adequacy, supervisory review, and transparency and market discipline are consistent with these proposals.

Several key conclusions and policy messages can be highlighted at the outset.

- Effective risk management in Islamic banks (and a risk-focused supervisory review process) requires that a high priority be given to proper measurement and disclosure of the following three risk types:
  - Aggregate banking risks (to reflect the volatility of *mudarabah* profits accruing to IAHs).
  - Specific types of risks (to control effectively the extent of credit, market, operational, and liquidity risks).
  - Facility-specific risks (to properly price individual facilities by measuring the full range of risks embedded in each facility).
- The unique mix of risks in Islamic finance and the potential role of IAHs in sharing some of the risks call for a strong emphasis on proper risk measurement, and disclosure of both risks and risk management processes in Islamic banks.

- Ensuring progress in risk measurement, disclosure, and risk management will, however, requires a multi-pronged effort for the following purposes:
  - To strengthen accounting standards and harmonise them with prudential standards.
  - To initiate a systematic data compilation process to enable proper risk measurement, including through developing central credit and equity registries suitable for Islamic finance.
  - To build a robust governance and creditor/investor rights infrastructure that would foster Islamic money and capital markets—based on innovative uses of asset securitisation—as a foundation for effective on-balance sheet risk management, including through transparent apportioning of risks to IAHs.
  - To foster this transformation of investment accounts into an effective component of risk management (in addition to collateral and guarantees) through product innovations supported by proper disclosure and reserving policies that make transparent the extent of risk being borne by the investment accounts, and the risk–return mix being offered.
  - To provide supervisory incentives for effective risk sharing with PSIA, by linking the capital adequacy treatment of PSIA to the extent of actual risks shared with PSIA, and by requiring adequate disclosure of these risks as a basis for "capital relief" (that is, the exclusion of part or all of risk-weighted PSIA-financed assets from the denominator of the CAR).

All this will set the stage for the eventual adoption of more advanced capital measurement approaches set out in Basel II and Basel III, and their adaptations for Islamic finance as outlined in the relevant Islamic Financial Services Board (IFSB) standards. The chapter highlights some of the measurement issues arising from the unique risk characteristics of Islamic finance contracts and policy considerations in promoting effective risk sharing between owners and investment accounts holders. A VaR methodology for measuring and monitoring such risk sharing is proposed.

2. BACKGROUND

Recent work on risk issues in Islamic finance has stressed that features of Islamic banks, and the intermediation models that they follow, entail special risks that need to be recognised to help make risk management in Islamic banking truly effective. Karim (1996) and Hassan (2000) have noted that the

traditional approach to capital adequacy and supervision based on the 1988 Basel Capital Accord—Basel I—did not adequately capture the varied risks in Islamic finance facilities. In a similar vein, recent studies in the Islamic Development Bank discuss the special risks in Islamic banks (Chapra and Khan 2000; Khan and Ahmed 2001). These studies survey the risk management practices of Islamic banks and note that Basel II provides scope for proper recognition of risks in Islamic banking products—through a more risk-sensitive system for risk weighting of assets and stronger incentives for effective risk management. (However, in the light of subsequent events and of Basel III, it should be noted that liquidity risk was not covered in Pillar 1 of Basel II and was not highlighted in Pillar 2). These studies also highlight a set of issues in Islamic jurisprudence (*fiqh* issues) that need to be resolved to facilitate effective supervision and risk management. Implications of risk sharing with PSIA for the governance, financial reporting, and capital adequacy of Islamic banks are discussed in Al-Deehani, Karim, and Murinde (1999), Archer and Karim (2005, 2006, 2012) and Archer, Karim and Sundararajan (2010). A recent World Bank study (El-Hawary, Grais, and Iqbal 2004) considered the appropriate balance of prudential supervision and market discipline in Islamic finance, and the related implications for the organisation of the industry. In parallel, recent studies from the International Monetary Fund focus on the financial stability implications of Islamic banks (Sundararajan and Errico 2002; Marston and Sundararajan 2003; Sundararajan 2004). These studies also stress the importance of disclosure and market discipline in Islamic finance (see also Archer and Karim 2006); they also note that in addition to the unique mix of risks, for a range of risks, Islamic banks may be more vulnerable than their conventional counterparts, owing in part to the inadequate financial infrastructure for Islamic banks, including missing instruments and markets and a weak insolvency and creditor rights regime, factors that limit effective risk mitigation.

Therefore, systemic stability in financial systems with Islamic banks requires a multi-pronged strategy to bring about:

- A suitable regulation and disclosure framework for Islamic banks.
- A robust financial system infrastructure and adequate macroprudential surveillance to provide the preconditions for effective supervision and risk management.
- Strengthened internal controls and risk management processes within Islamic banks.

Accordingly, a comprehensive risk-based supervision framework is needed for Islamic banks, supported by a clear strategy to build up risk management processes at the level of the individual institutions, and robust

legal, governance, and market infrastructure at the national and global levels. In recognition of this need, the international community established in 2002 the Islamic Financial Services Board (IFSB), headquartered in Kuala Lumpur, Malaysia, to foster good regulatory and supervisory practices, to help develop uniform prudential standards, and to support good practices in risk management.[3]

The IFSB has advanced the work on the capital adequacy framework and risk management in Islamic banks through the issuance of standards on these topics in December 2005 (see IFSB 2005a, 2005b). In addition, it has issued corporate governance standards, disclosure standards to promote transparency and market discipline, and standards for the supervisory review process. Recent discussions coordinated by the IFSB and the Islamic Development Bank have again reinforced the importance of building a robust financial infrastructure for Islamic finance—which constitutes the precondition—to support the sound functioning and effective supervision of Islamic banks.[4]

In particular, the effective supervision of Islamic banks requires that the three-pillar framework of Basel II and the language of risks it introduces be adapted appropriately to their operational characteristics. Key issues in the measurement and monitoring of specific risks and risk sharing in Islamic finance are first reviewed before considering policy implications.

3. TYPES OF RISKS IN ISLAMIC FINANCE AND THEIR MEASUREMENT

A key feature of Islamic banks is the potential sharing of risks between IAHs who provide funds on a mudarabah basis, and the Islamic banks that invest these funds (often commingled with shareholders' and other funds) in various Islamic finance contracts that include *murabahah*, *salam*, *mudarabah*, *musharakah*, *ijarah*, *istisna'a*, and other *Shari'ah*-compatible financing arrangements, including *sukuk*. This section reviews the overall risks facing Islamic banks in light of their financing activities on the asset side, modalities of sharing these risks with fund providers, and the types of risk embedded in individual Islamic finance contracts on the asset side of Islamic banks.

3.1 *Mudarabah* Risk

The way risks are shared between IAHs who invest on a *mudarabah* basis, and the bank as a *mudarib*, plays a crucial role in Islamic finance. The share of unrestricted investment accounts in the total deposits of Islamic banks varies considerably, from near zero (holding only demand and savings deposits) to

over 80 percent in some banks (Exhibit 3.1). The implications of such PSIA for risk measurement, disclosures, and bank governance generally have been the topic of several studies (see Clode 2002; AAOIFI 1999; Archer and Karim 2006). In this section, we will highlight specific risk measurement issues that need to be addressed in monitoring the risk–return tradeoff in PSIA. The focus is on the financial risks faced by the unrestricted investment accounts; for restricted investment accounts, the risks for banks and depositors are those

EXHIBIT 3.1 Disclosure Practices of Islamic Banks

Items of Disclosure	Comments
Risk management framework and practices	Disclosures are presented at a very general level and occasionally mention the existence of specific committees, such as the ALM committee.
Classification of facilities by asset quality, and data on nonperforming loans	All banks disclose classification of facilities by supervisory categories such as current, substandard, and so on. Only some banks (30%) disclose nonperforming loans. Only one bank mentioned the use of an internal rating system.
Specific provisions	Most banks (94%) disclose this as a total. Provisions as a percentage of assets varied from less than 1% to 6%. Only some banks (30%) disclose provisions classified by facilities.
Sectoral distribution of credit and connected exposures	Many banks (66%) disclose this.
Large exposures	Very few banks (6%) disclose this.
Capital adequacy	All banks disclose capital asset ratios—ranging from 2.5% to 38.4%, while many (66%) disclose regulatory capital to risk-weighted assets.
Value-at-risk (VaR)	None disclose this; one bank reported using VaR.
Liquidity ratios	All banks disclose various liquid asset ratios. Ratio of liquid assets to short-term liabilities ranged from 13% to 144%.
Maturity gap	Many banks (64%) disclose gaps at various maturity buckets.
Deposit composition: share of investment deposits to total deposits	Generally disclosed, ranging from 0% to 95%, and averaging 80%, with some banks (36%) reporting no investment deposits.
Composition of facilities: share of equity-type assets to total assets	Generally disclosed. Share of equity varied from less than 1% to about 23%, with a significant year-to-year change in some banks.

(*Continued*)

EXHIBIT 3.1 (*Continued*)

Items of Disclosure	Comments
Return on assets	Generally disclosed; large variation from 0.5% to 4.3%.
Return on equity	Generally disclosed; large variation from 0.7% to 58%.
Return on unrestricted investment deposits	All banks disclose this, with returns ranging from 1.45% to 16.35%, depending on country and bank.
Commodity inventories	Only some banks (30%) disclose this.
Return on restricted investment deposits	Very few (only one bank in the sample) disclose this.
Profit equalisation reserves	Some banks (30%) disclose this.
Net open position in foreign exchange	Many banks (66%) disclose this; the ratio as a percentage of capital varied from 0% to 100%.
Foreign currency liabilities to total liabilities	Many banks (66%) disclose this; the ratio varied from 0% to 100%.

Based on annual reports of 15 sample Islamic banks covering the years 2002 and 2003. Percentages of sample banks that disclose a particular item are shown in parentheses.

attributable to the specific assets to which the investment account returns are linked, and the risk measurement issues discussed in this chapter can be readily applied to the relevant asset portfolio. Both restricted and unrestricted IAHs also face fiduciary risks—risks of negligence and misconduct—reflected in the quality of internal controls, corporate governance, and risk management processes of the Islamic banks acting as *mudarib*.

In its most general form, risk is uncertainty associated with a future outcome or event. To an IAH in an Islamic bank, the risk is the expected variance in the measure of profit distributions where the profit is shared between the IAH and the bank. This variance could arise from a variety of both systemic and idiosyncratic (that is, bank-specific) factors. Actual risk in the investment account (that is, in the underlying investments) may be dampened in practice by the use of profit equalisation reserves (PER), investment risk reserves (IRR), and by variations in the *mudarib*'s share. The PER is used to reduce or eliminate the variability of profit payouts on investment deposits, to redistribute income over time, and to offer returns (payouts) that are aligned to market rates of return on conventional deposits or other benchmarks, without the need for the bank to forgo any of its *mudarib* share. In addition, banks may use the IRR to redistribute over time the incomes accrued to the investment accounts so as to maintain a payout when a periodic loss is incurred. Nevertheless, from an investor's point of view, the true risk of *mudarabah* investment in a bank can be measured by a

simple profit-at-risk (PaR) measure. For example, σ_p, the standard deviation of the periodic (for example, monthly or quarterly) profit payout[5] as a percentage of assets, provides the basis for the simplest measure of the risks of holding an investment account after the application of the above methods of "smoothing." In banks that practice such smoothing, this risk will of course be lower than the risk of the underlying assets, measured based on the standard deviation of the unsmoothed profits. One issue is how important it is for IAHs to be aware of this underlying risk.

From a monthly time series of *mudarabah* profit payouts (as a share of assets), its variance (and the standard deviation σ_p) can be calculated, and, assuming normality, profit-at-risk can be calculated as:

$$\text{PaR} = Z\alpha\sigma_p\sqrt{T}$$

Where: $Z\alpha$ = the constant that gives the appropriate one-tailed confidence interval with a probability of $1 - \alpha$ for the standard normal distribution (e.g. $Z_{.01} = 2.33$ for a 99 percent confidence interval).

T = the holding period or maturity of the investment account as a fraction of a month.

Such aggregate PaR for an Islamic bank as a whole provides a first-cut estimate of risks attaching to profit payouts in unrestricted *mudarabah* accounts. Such risk calculations could also be applied to individual business units within the bank (also for specific portfolios linked to restricted IAHs). In addition, if specific risk factors that affect the variation in *mudarabah* profit payouts can be identified, this measure σ_p can be decomposed further in order to estimate the impact of individual risk factors, and this would help to refine the PaR calculation. In practice, however, profit equalisation reserves and investment risk reserves are actively used by Islamic banks to smooth the return on investment accounts. As a result, risks in investment accounts are absorbed, in part, by banks themselves, in so far as the PER is strongly positively correlated with net return on assets (gross return on assets minus provisions for loan losses)—that is, PER is raised or lowered when the return on assets rises or falls, and hence the profit payout on the investment accounts is smoothed, and low or zero payouts are avoided except in the case of a loss when recourse is made to the IRR. Banks can also adjust their share of profits to maintain adequate returns to shareholders. As noted above, such absorption of risks by bank capital is referred to as "displaced commercial risk." The correlation between the movements on the PER and the asset return could, therefore, be viewed as an indicator of DCR. Thus, the precise relationship between the risk to IAHs and the aggregate risk

for the bank as a whole arising from the variability of net return on assets (gross return net of specific provisions) depends upon the policies toward profit equalisation reserves, investment risk reserves, and *mudarib*'s share. These policies determine, in effect, the extent of risk sharing between investment accounts and bank capital. These relationships are discussed further in Section 4 of the chapter.

Against this background, the true risks borne by IAHs can be made transparent by disclosing the definition of *mudarabah* profits, the level and variations in these profits and in profit equalisation reserves, as well as policies toward establishing PER[6] that will determine the variance in its movements as well as their correlation with the asset return. At the same time, transparency of internal controls and governance arrangements, including risk management processes, would also be important to provide assurances of integrity of Islamic banks as a *mudarib*. The measurement of such fiduciary risk could be subsumed under operational risk measurement, as discussed in Section 3.6.[7]

3.2 Credit Risks in Sales-Based Contracts

Murabahah and other sales-based facilities (*istisna'a*, *salam*, and so on) together with lease-based facilities (*ijarab*) dominate the asset side of Islamic banks, ranging from 80 to 100 percent of total facilities. Equity-type (profit- and loss-sharing *musharakah* or profit-sharing and loss-bearing *mudarabah)* facilities still constitute a negligible proportion of assets in most banks. Thus, credit risk in the normal sense—the risk of losses in the event of default of the borrower or in the event of a deterioration of the borrower's repayment capacity[8]—is the most common source of risks in an Islamic bank, as in conventional banks.[9] The methods of measurement of credit risks in conventional banks apply equally well to Islamic banks, with some allowance required to recognise the specific operational characteristics and risk-sharing conventions of Islamic financial contracts.

Credit risk can be measured based on both the traditional approach that assigns each counterparty into a rating class (each rating corresponding to a probability of default) as well as more advanced credit VaR methods discussed later in the section. The basic measurement principle under both these approaches is to estimate the expected loss on an exposure (or a portfolio of exposures) owing to specified credit events (default, rating downgrade, some non-performance of a specified covenant in the contract, and so on) and also to calibrate unexpected losses (losses that exceed a specified number of standard deviations from the mean) that might occur at some probability level. Expected losses are provisioned and regarded as an expense that is deducted from income, while unexpected losses (up to a tolerance level) are

backed up by capital allocation. The risk weights attached to various exposures on the bank's asset side (in the New Basel Capital Accord, for example) in effect represent the bank's or supervisor's judgment on the unexpected losses on the exposures that should be absorbed by capital. The calculation of loss—both expected and unexpected—in an individual loan will require estimates of:

- Probability of default (or probabilities of rating downgrades from one rating class to another).
- Potential credit exposures at default (or at the time of rating transition).
- Loss-given default (or reduction in the value of the asset following a rating transition).

Proper measurement of these three components of credit risk, and the calculation of unexpected losses, are the fundamental requirements of the Basel Capital Accords (Basel II and III). Measurement of these components for the case of sales-based contracts—*murabahah* and *salam*—is discussed next.

The default could be defined in the same way as for conventional banks, based on the financial condition of the borrower and the number of days the contract is overdue.[10] Estimation of the probability of default is traditionally based on *ex-ante* assignment of ratings to counterparty exposures or a portfolio of exposures of a particular variety (such as all commodity *murabahah* for a class of goods). A modern approach that can be used for larger listed companies is based on market information on equity prices. Observed market value of a firm's equity and estimated volatility of equity prices can be used to estimate the likelihood of default using the option pricing approach to bankruptcy prediction.[11] In practice, various methods can be combined during the risk management process in order to arrive at a credit rating and the associated probability of default based on historical experience. The estimation of probabilities—or correct assignment of ratings—will, however, require historical data on loan structure and performance, borrower characteristics, and the broader industry and macroeconomic environment; and thus the ratings will change over time as financial conditions and environment change.

Losses will clearly depend upon the potential credit exposures at the time of default (exposure at default, or EAD). In general, exposure at default would be facility-specific, depending upon the extent of discretion that the borrower can exercise in drawing down lines of credit, prepaying already drawn accounts, or any specific events that affect the value of contingent claims (for example, guarantees to third parties). In *murabahah* and *salam* contracts, EAD in most cases would simply be the nominal

value of the contract. In long-term *ijarah* (leasing) and *istisna'a* contracts, EAD will depend upon projected environmental factors that will be facility-specific.

Losses will ultimately depend upon the rate of recovery following default, or, in a mark-to-market model, the reduction in the value of the loan if ratings change. Loss-given default (LGD—that is, 1 minus *recovery rate* times *EAD*) is likely to depend upon ease of collecting on the collateral, the value of the collateral, the enforceability of guarantees, if any, and, most importantly, on the legal environment that determines creditors' rights and the features of insolvency regime. For example, the juristic rules for *murabahah* imply that "in case of insolvency, [the] creditor should defer collection of the debt until he [the debtor] becomes solvent."[12] The precise interpretation of such considerations would determine the length of time needed to recover overdue debt. In addition, there could be legal risks owing to difficulties in enforcing Islamic finance contracts in certain legal environments.[13] Moreover, the inability of Islamic banks to use penalty rates as a deterrent against late payments could create both a higher risk of default and longer delays in repayments.[14] Finally, the limitations on eligible collateral under Islamic finance—or excessive reliance on commodities and cash collateral—may exacerbate credit risks generally, and reduce the potential recovery value of the loan if commodity collateral proves too volatile in value. For these reasons, LGD in *murabahah* facilities could be different, probably higher, than in conventional banks, thereby affecting the size of losses and capital at risk.

Given the estimates of probability of default (PD), or probabilities of transition from one rating class to another (transition matrix), and the estimated LGD (or change in value of the loan for any given transition from one rating class to another), the expected and unexpected losses can be readily computed. For example, in the default model, expected loss (EL) is given by:

$$\mathrm{EL} = \mathrm{PD} \times \mathrm{LGD} \times \mathrm{EAD}$$

Where: LGD is expressed as a proportion of exposure at default.

The unexpected loss (UL) can be calculated based on assumptions on the distribution of default and recoveries. Assuming that LGD is fixed, and that borrowers either default or do not default, the default rate is binomially distributed, and the standard deviation of the default rate is:

$$\sigma = \sqrt{[\mathrm{PD}(1 - \mathrm{PD})]}$$

Therefore, a measure of UL on the loan is:

$$\mathrm{UL} = Z_{\alpha}\sqrt{[\mathrm{PD}(1-\mathrm{PD})] \times \mathrm{LGD} \times \mathrm{EAD}}$$

Z_{α} is a multiple (for example, a normal deviate) that limits the probability of unexpected losses to a specified level. This is the value-at-risk for this credit facility, representing the amount of capital needed to cover the unexpected loss in this exposure. In the case of a mark-to-market model, the calculation of EL and UL takes into account the prospects for both upgrades as well as downgrades of the loan; it considers the change in value of the loan for each possible change in the rating of a facility from its current level, and the corresponding probability of rating transition.[15]

While similar considerations apply in the case of *salam* contracts for calculating counterparty credit risk, there is an additional commodity price risk embedded in these contracts that should be added to the credit risk. The commodity price risk will arise even when the counterparty does not default, and when there is default (for example, delivery of a substandard good, delayed delivery of a good, etc.) the commodity price risk—taking into account any offsetting parallel *salam* positions—could be included as part of the LGD. Thus, potential loss in a *salam* contract is the sum of the loss due to credit risk and the loss due to commodity price risk, assuming that delivery takes place according to the contract (that is, there is no credit risk loss). In addition, there could be a correlation between these two types of risk (for example, due to common factors such as drought that could affect both commodity price risk and counterparty credit risk), which could be estimated based on historical data but is ignored for the time being for simplicity. In the absence of liquid commodity markets as well as *Shari'ah*-compatible hedging products to mitigate price risks, commodity price risk can be measured by calculating the value-at-risk of commodity exposures in different maturity buckets using historical data on prices. While commodity exposures can be treated as part of market risk measurement for capital allocation purposes, it is important to compute this market risk separately for each *salam* contract or for a portfolio of *salam* contracts and to add it to the credit risk so that the full risk in each contract (or portfolio of contracts) can be properly measured and taken into account in the pricing of the contract (or the facility). Also, the estimated commodity price risk should be monitored regularly, as price volatility could change over time due to shifts in macroeconomic and market-specific conditions.

Finally, credit risk of a portfolio of exposures and facilities could be lower or higher depending upon the extent of diversification or concentration

in specific credit categories. The credit risk measurement can take into account the benefits of diversification by computing the joint distribution of default events based on correlations between different classes and segments of the portfolio—that is, correlations between defaults among counterparties and the joint probability of default of any pair or group of counterparties can be estimated. This can form the basis for valuing the loan portfolio and computing the expected loss in the loan portfolio as a whole, based on the joint distribution of components of the portfolio. In some models, default rates and transition probabilities can be made a function of macroeconomic variables. The probability distribution of gains and losses of the loan portfolio, or the loan facility, can then be used to compute both expected and unexpected losses (at a given probability level). In case of loans to a diversified group of individuals and small businesses, with standard instalments and commodity leases, supervisors and banks might treat the class of loans as a retail exposure with a smaller risk weight (reflecting lower value-at-risk due to diversification effects). At the same time, credit concentrations by sectors and rating classes should be monitored as alternative indicators of credit risk.

3.3 Equity Risks in *Mudarabah* and *Musharakah* Facilities

These are equity-type facilities, typically a very small share of total assets in part reflecting the significant investment risks that they carry. In a sample of Islamic banks, the share of *mudarabah* and *musharakah* facilities (as mentioned earlier, in the latter both partners share in the profit and/or loss of the venture) and traded equities varied from 0 to 24 percent, with a median share of about 3 percent. The possible unexpected losses in such equity-type contracts will depend upon the functions of the underlying enterprise or venture in which the bank acquires an equity exposure.[16] In a venture formed for trading in commodities or foreign exchange, the equity position risk arises from the risk of underlying transactions by the venture. A measure of the potential loss in equity exposures in business enterprises that are not traded can be derived based on the standard recommended in Basel II (paragraph 350) and the IFSB Standard for "equity position risk in the banking book."[17] In addition, a *mudarabah* facility may need to be assigned an additional UL due to operational risk factors, with the extent of operational risk adjustment depending on the quality of internal control systems to monitor *mudarabah* facilities on the asset side. High-quality monitoring would be very important in Islamic banks, since the finance provider cannot interfere in the management of the project funded on a *mudarabah* basis. In the case of *musharakah*, the need for operational risk

adjustment may be less, in so far as the bank exercises some management control. If the bank's equity interest in a counterparty is based on regular cash flow and not capital gains, and is of a long-term nature linked to customer relationship, a different supervisory treatment and a lower LGD could be used. If, however, equity interest is relatively short term, relies on capital gains (for example, traded equity), a VaR approach, subject to a minimum risk weight of 300 percent, could be used to measure capital at risk (as proposed in Basel II).

3.4 Market Risks and Rate of Return Risks

The techniques of market risk measurement in the trading books of Islamic banks should be broadly identical to those in conventional banks. The trading book in Islamic banks, however, is likely to be limited to traded equities, commodities, foreign exchange positions, and, increasingly, various forms of *sukuk*. A large share of assets of Islamic banks also consists of cash and other liquid assets, with such short-term assets typically exceeding short-term liabilities and amounts that IAHs are entitled to withdraw at short notice by a large margin, in part reflecting the limited availability of *Shari'ah*-compatible money market instruments. Against this background, exposure to various forms of market risk can be measured by the traditional exposure indicators, such as:

- Net open position in foreign exchange.
- Net position in traded equities.
- Net position in commodities.
- Rate-of-return gap measures by currency of denomination.
- Various duration measures of assets and liabilities in the trading book.

Most Islamic banks compute and often disclose liquidity gap measures—the gap between assets and liabilities at various maturity buckets—and hence the computation of the rate-of-return or repricing gap should be fairly straightforward. More accurate duration gap measures may also be available in some banks. Gap and duration measures, and their availability in banking statistics, are discussed in the *Compilation Guide for Financial Soundness Indicators* (IMF 2004). Duration measures are important indicators of financial soundness, but they are not readily available in many banking systems. Baldwin (2002) discusses duration measures in the context of Islamic banking. The impact on earnings of a change in exchange rate, equity price, commodity price, or rates of return can be directly obtained by multiplying the appropriate gap or other exposure

indicators by the corresponding price change. Such a simple approach will not, however, suffice for computing the impact of changes in interest rates on equity-type exposures of fixed maturity (such as *mudarabah* and *musharakah*). The impact of changes in the rates of return on the expected rate of profits (that is, *mudarabah* and *musharakah* income) would need first to be computed, or equivalently the equity exposures should be adjusted by a multiplicative factor (which a supervisor can specify) before computing gaps in each maturity bucket.

Such gap measures may not, however, capture the maximum losses that could occur (at some probability level), particularly in Islamic banks. They do not properly recognise other market-related risks arising from changes in the spread over benchmark rates, or twists in the yield curve, or shifts in market volatility, which could affect potential losses. For these reasons, market risk is commonly measured by various VaR measures. This is particularly important, given the likely importance of equities and commodities in Islamic bank balance sheets, which have potential to cause large losses. For example, for both equities and commodities, VaR based on a 99 percent confidence level (one-sided confidence interval) could be computed. VaR could be based on quarterly equity returns (*mudarabah* or *musharakah* profit rate) net of a risk-free rate,[18] or quarterly or monthly changes in commodity prices.

In most Islamic banks, the rate-of-return risk in the banking book is likely to be much more important than market risk in the trading book.[19] The rate-of-return gap and duration gap applied to the banking book would provide measures of exposures to changes in benchmark rates of return, and of the impact of these changes on the present value of bank earnings. For example, a simple stress test of applying a 1-percentage-point increase in rates of return on both assets and liabilities maturing—or being reprised—at various maturity buckets would yield a measure of potential loss (or gain) due to a uniform shift in term structure of rate of return.[20]

Another important source of risk is the possible loss due to a change in the margin between domestic rates of return and the benchmark rates of return (such as LIBOR), which may not be closely linked to the domestic return. Many Islamic banks use an external benchmark such as LIBOR to price the mark-up in *murabahah* contracts, in part reflecting the lack of a reliable domestic benchmark rate of return. If domestic monetary conditions change, requiring adjustments in returns on deposits and loans, but the margin between the external benchmark and domestic rates of return shifts, there could be an impact on asset returns. This is a form of "basis risk" that should be taken into account in computing the rate-of-return risk in the banking book (and also market risks). The existence of this basis risk highlights the importance of developing a domestic

rate-of-return benchmark so that both deposits and assets can be aligned to similar benchmarks.

3.5 Liquidity Risk

This risk is interpreted in numerous ways, such as extreme liquidity, availability of liquid assets to meet liabilities, and the ability to raise funds at normal cost. This is a significant risk in Islamic banks, owing to the limited availability of *Shari'ah*-compatible money market instruments and lender of last resort (LOLR) facilities. A standard measure of liquidity risk is the liquidity gap for each maturity bucket and in each currency. The share of liquid assets to total assets or to liquid liabilities is also a commonly used measure. While the availability of core deposits (current accounts and investment accounts) which are rolled over, and not volatile, provides a significant cushion for most Islamic banks, the remaining volatile deposits cannot be readily matched with short-term liquid assets, other than cash and other low-yielding assets.

In addition, specific aspects of Islamic contracts could increase the potential for liquidity problems in Islamic banks. These factors include: cancellation risks in *murabahah*, the *Shari'ah* requirement to sell *murabahah* contracts only at par, thereby limiting the scope for secondary markets for sale-based contracts, the illiquidity of commodity markets, and prohibition of secondary trading of *salam* or *istisna'a* contracts (see Ali 2004).

Management of liquidity risk in Islamic banks is complicated by the dearth of liquid instruments offering *Shari'ah*-compliant returns (including "high quality liquid assets" as required by Basel III), and of *Shari'ah*-compliant interbank markets and lender-of-last-resort facilities.

3.6 Operational Risk

Operational risk is defined as "the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This includes legal risk, but excludes strategic and reputation risk."[21] Such risks are likely to be significant in Islamic banks, due to specific contractual features and the general legal environment. Specific aspects that could raise operational risks in Islamic banks include the following: (1) the cancellation risks in nonbinding *murabahah* and *istisna'a* contracts; (2) problems in internal control systems to detect and manage potential problems in operational processes and back-office functions; (3) technical risks of various sorts; (4) the potential difficulties in enforcing Islamic finance contracts in a broader legal environment; (5) the risk of non-compliance with *Shari'ah* requirements that may impact on permissible income; (6) the risk of

"misconduct and negligence" which would result in *mudarabah*-based PSIA becoming a liability of the Islamic bank, with consequent capital adequacy and solvency implications; (7) the need to maintain and manage commodity inventories, often in illiquid markets; and (8) the potential costs and risks in monitoring equity-type contracts and the associated legal risks. In addition, the increasing use of structured finance transactions—specifically, securitisation of assets originated by banks—could expose banks to legal risks.

The principle of setting a capital requirement in the form of a risk-weighted-asset equivalent for operational risk is subject to discussion, since operational risks pertain to a bank's systems and procedures, not to its assets or balance sheet positions as such. It has to be said that the treatment of this risk in relation to capital requirements was a new departure in Basel II. The three methods based on "gross income" are undoubtedly crude when applied to conventional banks; in the case of Islamic banks, this is true *a fortiori*. The use of gross income as the basic indicator for operational risk measurement could be misleading in Islamic banks, in so far as a large volume of transactions in commodities and the use of structured finance raise operational exposures that will not be captured by gross income. The standardised approach that allows for different business lines is better suited, but still requires adaptation to the needs of Islamic banks. In particular, agency services under *mudarabah*, the associated risks due to potential misconduct and negligence, and operational risks in commodity inventory management all need to be explicitly considered for operational risk measurement.

3.7 Mix of Risks by Type of Product

The above review of risk characteristics of Islamic products by type of risk poses a challenging issue of how to recognise the specific bundling of risks in individual Islamic finance products and the associated correlation among risks. Monitoring the mix of risks for each facility in a centralised and integrated manner is key to pricing the risks. First, all Islamic finance contracts—whether sales-based, leased asset-based, or equity-based—in light of the associated operations in commodities, and the need to monitor or intervene in governance and controls of counterparties in equity-based contracts, are exposed to a mixture of credit and operational risks. In addition, *murabahah* and *salam* contracts will also face commodity price risk; holdings of *sukuk*, for instance, will carry a mixture of credit, market, and operational risks. Also, the mix of risks will vary according to the stage of contract execution, as recognised in IFSB (2006).

4. OVERALL RISK OF AN ISLAMIC BANK AND APPROACHES TO RISK MITIGATION

Potential losses due to each category of risk could be quantified and aggregated to derive the total impact of the different risks and to examine the adequacy of capital to absorb the risks. However, it is unlikely that the unexpected losses will exceed their upper bounds at the same time for different types of risk, and the arithmetic total of individual risks will be an overestimate of the aggregate VaR for the bank as a whole. Such an aggregate VaR is, however, important for informing unrestricted IAHs of Islamic banks, who are expected to share in the overall risks. An overall risk measure could be obtained from historical distribution of earnings and calculating earnings volatility, as already discussed.

A key issue for Islamic banks is to manage the risk-sharing properties of investment accounts—both restricted and unrestricted—in order to mitigate some of the risks to shareholders. Thus, in addition to collateral, guarantees, and other traditional risk mitigants, the management of the risk–return mix, particularly of unrestricted IAHs, could be used as a key tool of risk management. Appropriate policies toward profit equalisation reserves (and, possibly, investment risk reserves), coupled with appropriate pricing of investment accounts to match the underlying risks, would improve the extent of overall risk sharing by these accounts. Under current practices, reserves are passively adjusted to provide a stable return to unrestricted IAHs, effectively not allowing any risk mitigation through investment account management—that is, management of the risks and returns of the underlying assets in order to produce the desired outcomes.[22] For example, many banks with sharply divergent risk profiles and returns on assets seem to be offering almost identical returns to unrestricted IAHs, and these are broadly in line with the general rate of return on deposits in conventional banks.

These relationships have been analyzed empirically in Sundararajan (2005). The evidence reveals a significant amount of return smoothing and a significant absorption of risks by bank capital (and thus, only a limited sharing of risks with IAHs). This finding raises a broader issue of how best to measure empirically the extent of risk sharing between unrestricted investment accounts and bank capital.

A specific framework for such measurement is suggested further on. The definition and measurement of *mudarabah* profits are first discussed; a methodology is then presented for calibrating risk sharing between IAHs and bank owners based on a VaR methodology.

4.1 Accounting Definitions

The relationship between *mudarabah* income and overall return on bank assets can be specified based on available accounting standards. Drawing on this relationship, a methodology to measure the risks facing IAHs, and the risk sharing between bank owners and IAHs, is suggested.

According to Financial Accounting Standard No. 6 (FAS 6) of the Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI), when a bank commingles its own funds (K = Capital) and current account (CA) funds guaranteed by the bank (so that these count as part of the *mudarib*'s funds for risk-bearing and profit-sharing purposes) with *mudarabah* funds (DI = unrestricted IAH), profits are first allocated between the *mudarib*'s funds K + CA and the funds of investment account holders, DI, and then the share of Islamic bank as a *mudarib* for its work is deducted from the share of profits of the IAHs.

In addition, FAS 6 states that profits of an investment jointly financed by the Islamic bank and unrestricted IAHs shall be allocated between them according to the contribution of each of the two parties in the jointly financed investment. Allocation of profit based on percentages agreed upon by the two parties is also juristically acceptable (according to the principle of *musharakah*), but the standards call for proportionate contribution.

The minimum standard for calculating the rate of return—specified by the Bank Negara Malaysia in the *Framework of the Rate of Return* (2001, and revised 2004)—calls for the sharing of profits between depositors (i.e., unrestricted IAHs) and the bank as *mudarib* to be uniform across banks as specified in the framework documents, and provides a uniform definition of profit and provisions to ensure a level playing field. Profit is defined as income from balance sheet assets plus trading income minus provisions, minus appropriations to (or plus releases from) profit equalisation reserves, minus the income attributable to capital, specific investments, and due from other institutions. This is the *mudarabah* income (RM) distributable between investment depositors (unrestricted IAHs) and the bank (as *mudarib*). Provisions are defined as general provisions plus specific provisions and income-in-suspense for facilities that are non-performing. The framework then distributes *mudarabah* income between the IAHs and the bank as *mudarib* and then by type and structure of IAH deposits.[23]

In addition, both AAOIFI standards and the rate of return framework of the Bank Negara Malaysia recognise the profit equalisation reserve and investment risk reserve (IRR). PER (or R_p) refers to amounts appropriated out of gross income in order to maintain a certain level of return for depositors (IAHs); and this is apportioned between IAHs and shareholders in the appropriate proportions that apply to the sharing of profits. IRR are

reserves attributable entirely to IAHs, but are maintained specifically to cover losses on investments made with their funds.[24]

4.2 Measuring Risks in Investment Accounts and Risk Sharing

Given the framework for the computation of *mudarabah* profit—to be apportioned between the *mudarib* and the unrestricted IAH—and the policies on PER and IRR, the risk (defined as unexpected losses) of investment deposits can be calculated based on the variance of the rate of return for IAHs. Computation of such unexpected losses under alternative scenarios for income smoothing (that is, alternative policies on PER and IRR) can provide the basis for estimating the adjustment factor α, which is subject to supervisory discretion under the IFSB capital adequacy formula. This approach is based on the consideration that effective investment account management would help to determine a value for α that is consistent with the risk–return preferences of IAHs and the bank's response to these. A further elaboration of these issues, including precise approaches to estimation of α, is the subject of a separate paper (Archer, Karim, and Sundararajan 2010) and a Guidance Note issued by the IFSB (IFSB 2011).

5. SUMMARY AND POLICY CONCLUSIONS

The application of modern approaches to risk measurement, particularly for credit risk and overall banking risks, is important in Islamic finance for at least four reasons:

- To properly recognise the unique mix of risks in Islamic finance contracts.
- To ensure proper pricing of Islamic finance facilities, including returns offered to IAHs.
- To manage and control various types of risks, including operational and liquidity risks as well as credit and market risks.
- To ensure adequacy of capital and its effective allocation, according to the risk profile of the Islamic bank.

The preliminary review of the current state of financial reporting and disclosure among Islamic banks suggests that systematic future efforts at data compilation would be needed, particularly to measure credit and equity risks with some degree of accuracy. The situation is similar for many conventional banks, but the need to adopt new measurement approaches is

particularly critical for Islamic banks because of the role IAHs play, the unique mix of risks in Islamic finance contracts, and the need to make more active use of security markets and securitisation products for risk management. For these reasons, rapid progress is important in consumer-friendly disclosures to inform IAHs of the risk–return mix they face, and in market-oriented disclosures to inform markets of capital adequacy, risk exposures, and risk management.

In addition, managing the risk-sharing property of investment accounts through proper pricing, reserving, and disclosure policies would greatly enhance risk management in Islamic finance. This requires measurement and disclosure of aggregate value at risk of *mudarabah* income in the consolidated balance sheet of Islamic banks, and greater use of asset securitisation in order to offer assets of specific risk–return characteristics to IAHs. Also, a measure of the extent to which the risks to shareholders are reduced on account of risk sharing with IAHs should be the basis of any capital relief or lower risk weights on the assets funded by investment accounts. For example, the proposed capital adequacy standard for Islamic banks (IFSB 2005b) calls for supervisory discretion in determining the share, "α," of risk-weighted assets funded by PSIA that can be deducted from the total risk-weighted assets for the purpose of assessing capital adequacy. This share α represents the extent of total risk assumed by the PSIA, with the remainder absorbed by the shareholders on account of displaced commercial risk.

These observations suggest several policy and operational considerations and proposals:

- Appropriate measurement of credit and equity risks in various Islamic finance facilities can benefit from systematic data collection efforts, including by establishing credit (and equity) registries.
- Islamic banks would require both centralised and integrated risk management that helps to control different types of risks while allowing disaggregated risk measurements designed to price specific contracts and facilities, including the risk–return mix offered to IAHs. This integrated approach to risks would need to be supported by appropriate regulatory coordination and cooperation among banking, securities, and insurance supervisors.
- The disclosure regime for Islamic banks needs to become more comprehensive and transparent, with a focus on disclosures of risk profile, risk–return mix, and internal governance. This requires coordination of supervisory disclosure rules and accounting standards, and proper differentiation between consumer-friendly disclosures to assist investment account holders, and market-oriented disclosures to inform markets.[25]

- The supervisory review process should monitor and recognise the actual extent of risk sharing by IAHs in assessing capital adequacy, thereby encouraging more effective and transparent risk sharing with IAHs. Adequate disclosure by an Islamic bank of the credit and market risks borne by PSIA and shareholders, respectively, should be a supervisory requirement for giving a low value to the "α" parameter in the capital adequacy formula to be applied to that Islamic bank. Thus, inadequate disclosure would result in a high value being set for this parameter (equivalent to granting little or no "capital relief" in respect of the share of these risks that might otherwise be considered to be borne by PSIA). The measurement of these risks, and estimation of appropriate capital relief, can be based on VaR methodology as suggested in Section 4.

NOTES

1. Clearly there is no juristic obligation under the *Shari'ah* for the bank to absorb risk for the benefit of IAHs; in fact, the reverse is true. But in some jurisdictions the central bank takes the view that, as unrestricted PSIA are marketed as a substitute for conventional deposits, the bank has a *constructive* obligation to maintain its capital intact and to pay a competitive return.
2. Since the restricted investment accounts are not generally considered as a substitute for conventional deposits, this issue does not normally arise for them, although as a matter of commercial policy a bank in a particular year may decide to waive part of its *mudarib* share from such accounts in order to offer a better return to the IAH.
3. See "IMF Facilitates Establishment of IFSB," IMF news brief no. 02/41, May 2002; http://www.imf.org/external/np/sec/nb/2002/nb0241.htm.
4. See papers presented at the seminar on *The Ten-year Master Plan for the Islamic Financial Services Industry*, held in Putrajaya, Malaysia, May 2005.
5. The amount need not be physically paid out, but may be credited to the IAH account, from where it can be either withdrawn or left as an addition to the balance invested.
6. The movements on IRR are also relevant, but are not explicitly included in this analysis for the sake of simplicity.
7. For a discussion of appropriate practices in defining *mudarabah* profits, see AAOIFI, Financial Accounting Standard No. 6, and the *Framework of the Rate of Return* (October 2001, and revised 2004) issued by the Bank Negara Malaysia. For examples of estimation of such earnings and PaR measures for Islamic banks, see Hakim (2003) and Hassan (2003).
8. In the case of an *ijarah-based* facility, the risk is that of default by the lessee—that is, failure to keep up lease payments. However, in an *ijarah*, the bank as lessor retains ownership of the leased asset and can normally repossess it in the event of default by the lessee.

9. *Musharakah-* and *mudarabah-based* facilities give rise to risks of nonperformance that are analogous to credit risk but are typically higher, as the customer has no legal obligation to repay capital or pay a return unless a profit is earned on the underlying investment. See Section 3.3.
10. Basel II definition (paragraph 452).
11. For a survey of new approaches to credit risk measurement and an overview of traditional methods, see Saunders and Allen (2002).
12. AAOIFI (2001), Financial Accounting Standard No. 2, Appendix B.
13. Djojosugito (2003).
14. Chapra and Khan (2000).
15. See Wilson (1998) and Caouette et al. (1999) for detailed illustration.
16. IFSB (2006).
17. Basel II also proposes another method whereby the loss can be estimated by using the PD corresponding to a debt exposure to the counterparties whose equity is being held, and applying a fairly high loss-given default such as 90 percent to reflect the equity risks. A measure of both expected and unexpected loss could then be computed from these parameters. However, the notion of "debt exposure" as such is problematic in Islamic finance, and this method is not proposed in the IFSB Standard, which suggests that the method proposed in Basel II based on "supervisory slotting criteria" for specialised lending may be adapted for such risks.
18. The concept of a risk-free rate is problematic in Islamic finance, since a risk-free return is not *Shari'ah*-compliant. However, the suggestion here is to use such a rate merely as a component in a calculation, not in an actual transaction.
19. In principle, in the presence of profit-sharing and loss-bearing investment account holders, the changes in asset returns due to changes in the benchmark market rate of return would be offset by corresponding shifts in the returns payable to IAHs. In practice, as a result of return smoothing, the risk of losses due to changes in market rates of return would remain significant.
20. Alternatively, the impact on the present value of earnings of shifts in the rate of return can be calculated directly from duration measures as follows: impact of change in rate of return = $(D_A - D_L)\Delta i_r$, where: D_A = duration of assets; D_L = duration of funding; and Δi_r = change in rate of return.
21. Basel II, paragraph 644.
22. In at least some cases this may, however, be a way of managing the different risk appetites of shareholders and investment account holders. The bank adopts a more aggressive investment strategy than would be appropriate for IAHs, and then uses "smoothing" methods to produce the outcomes for IAHs of a more defensive strategy. The investment accounts are thus used as a form of leverage. See Al-Deehani et al. (1999) and Archer and Karim (2005).
23. Thus, the income to the bank has two components: the return on bank capital used in calculating the *mudarabah* profits (this is the return to the bank's contribution as a co-investor) plus the *mudarib* share of the *mudarabah*'s profits. (This is the fee for its asset management services.)

24. It would not be *Shari'ah*-compliant for the PER to be used for this, as this would amount to the *mudarib* absorbing part of the loss.
25. The IFSB has issued a standard on *Disclosures to Promote Transparency and Market Discipline* (IFSB 2007).

REFERENCES

Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). 1999. *Statement on the Purpose and Calculation of the Capital Adequacy Ratio for Islamic Banks*. AAOIFI: Manama, Bahrain.

Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). 2001. Financial Accounting Standard No. 2, Appendix B. AAOIFI: Manama, Bahrain.

Al-Deehani, T., R.A.A. Karim, and V. Murinde. 1999. "The Capital Structure of Islamic Banks under the Contractual Obligation of Profit Sharing." *International Journal of Theoretical and Applied Finance* 2 (3): 243–83.

Ali, S. S. 2004. "Islamic Models of Finance and Associated Liquidity Risks." Paper presented at the conference on *The Monetary Sector in Iran: Structure, Performance & Challenging Issues*. Tehran, Iran, February.

Archer, S. and R.A.A. Karim. 2005. "On Capital Structure, Risk Sharing and Capital Adequacy in Islamic Banks." *The International Journal of Theoretical & Applied Finance* 9 (3): 269–80.

Archer, S. and R.A.A. Karim. 2006. "Corporate Governance, Market Discipline, and Regulation of Islamic Banks." *The Company Lawyer* 27 (5): 134–45.

Archer, S. and R.A.A. Karim. 2012. "The Structure, Regulation and Supervision of Islamic Banks." *Journal of Banking Regulation* 3:1–13.

Archer, S., R.A.A. Karim, and V. Sundararajan. 2010. "Supervisory, Regulatory and Capital Adequacy Implications of Profit Sharing Investment Accounts in Islamic Finance." *Journal of Islamic Accounting and Business Research* 1 (2): 243–83.

Artigas, C. T. 2004, September. *A Review of Credit Registers and their Use for Basel II*. Financial Stability Institute, Bank for International Settlements: Basel, Switzerland.

Baldwin, K. 2002. "Risk Management in Islamic Banks." In *Islamic Finance: Innovation and Growth*, edited by Simon Archer and Rifaat Ahmed Abdel Karim, 176–197. London: Euromoney Books.

Bank Negara Malaysia. 2001, October 16. "The Framework of the Rate of Return." Bank Negara Malaysia: Kuala Lumpur.

Bank Negara Malaysia. 2004, August. "Guidelines on the Specimen Reports and Financial Statements for Licensed Islamic Banks" (GP8-i). Kuala Lumpur: Bank Negara Malaysia.

Becker, S. 1998. "A Survey of Risk Management Theory and Practice." In *Risk Management and Analysis, Volume I. Measuring and Modeling Financial Risk*, edited by Carol Alexander, 39–60. New York: John Wiley & Sons.

Caouette, J. B., E. I. Altman, and P. Narayanan. 1999. *Managing Credit Risk: The Next Great Financial Challenge*. New York: John Wiley & Sons.

Chapra, M. U. and T. Khan. 2000. "Regulation & Supervision of Islamic Banks." Occasional Paper No. 3, Islamic Development Bank: Jeddah.

Clode, M. 2002. "Regulatory Issues in Islamic Finance." In *Islamic Finance: Innovation and Growth*, edited by Simon Archer and Rifaat Ahmed Abdel Karim, 67–73. London: Euromoney Books.

Djojosugito, R. A., "Relative Suitability of Civil and Common Law Regimes for Islamic Banking." Paper presented at the International Conference on Islamic Banking, Jakarta, Indonesia, September 30–October 2.

El-Hawary, D., W. Grais, and Z. Iqbal. 2004. "Regulating Islamic Financial Institutions: The Nature of the Regulated." Policy Research Working Paper 3227, The World Bank, Financial Sector Global Partnerships Department, March.

Financial Stability Institute. 2004. *Implementation of the New Capital Adequacy Framework in Non-Basel Committee Member Countries*. FSI Occasional Paper #4, Bank for International Settlements, Basel, Switzerland, July.

Hakim, S. 2003. "A Value-at-Risk Framework for Islamic Banks." Paper presented at the International Conference on Islamic Banking, Jakarta, Indonesia, September 30–October 2.

Hassan, K. 2003. "Value-at-Risk (VAR) Analysis of Islamic Banks." Paper presented at the International Conference on Islamic Banking, Jakarta, Indonesia, September 30–October 2.

Hassan, S. M. 2000. "Capital Adequacy and Basle Guidelines on Risk Weighted Assets for Islamic Banks." Paper presented at the conference on the Regulation of Islamic Banks, Bahrain, February 8–9.

International Monetary Fund. 2004. *Compilation Guide for Financial Soundness Indicators*. Washington, DC: International Monetary Fund.

International Organization of Securities Commissions (IOSCO). 2004. *Islamic Capital Market Fact Finding Report*. IOSCO public document 170, Madrid, Spain, July.

Islamic Financial Services Board (IFSB). 2005a. *Guiding Principles of Risk Management for Institutions (other than Insurance Institutions) Offering Only Islamic Financial Services*. Kuala Lumpur, Malaysia: IFSB.

Islamic Financial Services Board (IFSB). 2005b. *Capital Adequacy Standard for Institutions (other than Insurance Institutions) Offering Only Islamic Financial Services*. Kuala Lumpur, Malaysia: IFSB.

Islamic Financial Services Board (IFSB). 2007. *Disclosures to Promote Transparency and Market Discipline for Institutions offering Islamic Financial Services*

(excluding Islamic Insurance (Takaful) Institutions and Islamic Mutual Funds). Kuala Lumpur, Malaysia: IFSB.

Islamic Financial Services Board (IFSB). 2010. *GN4 Guidance Note in Connection with the IFSB Capital Adequacy Standard: The Determination of Alpha in the Capital Adequacy Ratio for Institutions (other than Insurance Institutions) Offering Only Islamic Financial Services*. Kuala Lumpur, Malaysia: IFSB.

Karim, R.A.A. 1996. "Impact of the Basel Capital Adequacy Calculation on the Financial and Marketing Strategies of Islamic Banks." *International Journal of Bank Marketing* 10 (December): 165–97.

Khan, T., and H. Ahmed. 2001. "Risk Management: An Analysis of Issues in the Islamic Development Bank." Occasional Paper No. 9, Islamic Development Bank, Jeddah.

Marston, D. and V. Sundararajan. 2003. "Unique Risks of Islamic Banks and Implications for Systemic Stability." Paper presented at the *International Conference on Islamic Banking*, Jakarta, Indonesia, September 30–October 2.

Miller, M. 2003. *Credit Reporting Systems and the International Economy*. Cambridge, MA: MIT Press.

Obaidullah, M. 2003. "Market Risk in Islamic Banks and the Relevance of Islamic Contract for Risk Management." Paper presented at the *International Conference on Islamic Banking*, Jakarta, Indonesia, September 30–October 2.

Saunders, A. and L. Allen. 2002. *Credit Risk Measurement: New Approaches to Value-at-Risk and Other Paradigms*. New York: John Wiley & Sons.

Sundararajan, V. 2004. "Development of Competitive and Innovative Islamic Financial Products and Markets: Key Issues and Policy Implications." Paper presented at the *International Seminar on Challenges Facing the Islamic Financial Services Industry*, Bali, Indonesia, April 1–2.

Sundararajan, V. 2005. "Risk Measurement and Disclosure in Islamic Finance and the Implication of Profit Sharing Investment Accounts." Sixth *International Conference on Islamic Economics, Banking and Finance*, Jakarta, Indonesia, November 22–24.

Sundararajan, V. and L. Errico. 2002. "Islamic Financial Institutions and Products in the Global Financial System: Key Issues in Risk Management and Challenges Ahead." IMF working paper WP/02/192, November.

Wilson, T. 1998. "Value at Risk." In *Risk Management and Analysis, Volume I. Measuring and Modeling Financial Risk*, edited by Carol Alexander, 61–124. New York: John Wiley & Sons.

CHAPTER 4

Risk in a Turbulent World: Insights from Islamic Finance[1]

Sami Al-Suwailem

1. INTRODUCTION

Despite the remarkable technological advances that humanity enjoys in our age, financial instabilities have been on the rise since the 1970s. The steady improvement in the stability of the real economy in the past few decades was accompanied by rising frequency and severity of financial crises (IMF 2007, ch. 5; 2009a, ch. 3). "The fact that the total risk of the financial markets has grown in spite of a marked decline in exogenous economic risk to the country is a key symptom of the design flaws within the system," noted Richard Bookstaber, Senior Policy Adviser to the Financial Stability Oversight Council in the United States (Bookstaber 2007, 5).

Further, recessions that precede banking and financial crises are more costly to the economy and have a longer negative impact than ordinary recessions. It takes on average four years for the economy to recover from a recession accompanied by a banking crisis, but only one year to recover from an ordinary recession (Reinhart and Rogoff 2009). Furthermore, cumulative loss in GDP in case of financial crises on average is 14 percent, compared to 5 percent in absence of crises (IMF 2008, ch. 4).

Islamic finance is characterised by the view that finance needs to be anchored in the real economy, which distinguishes it from conventional finance just as significantly as the well-known prohibition of interest. The basic principles nonetheless are shared with all faiths of divine origin. Islamic finance, in addition, provides a set of legal and ethical rules that, if adopted

Islamic Finance: The New Regulatory Challenge.
Edited by Simon Archer and Rifaat Ahmed Abdel Karim
Copyright © 2013 by John Wiley & Sons Singapore Pte. Ltd.
ISBN: 978-1-118-62897-3

properly, should greatly contribute to economic stability (Aziz 2010). This article aims to explore the role of risk in economic activities, and how it interacts with financial arrangements, from an Islamic-finance point of view. The article concludes with some recommendations for regulators to promote stability and productivity of the Islamic financial industry.

2. FUNCTIONS OF RISK

Uncertainty is inherent in our universe. At the most basic level of atomic particles, the uncertainty principle of Werner Heisenberg indicates the impossibility of our knowing the exact position and momentum of a particle (e.g., Kumar 2008). With uncertainty comes risk, that is, the likelihood of loss or failure.[2] Risk plays a major role in influencing our behavior and decisions in economic and social life in the following four ways:

1. Incentives. Risk is an important motivator for hard work and dedication. Suppose a student was assured that he faced no chance of failing the final exam no matter the quality of his performance. Would the student have sufficient incentives to study and learn? It is very unlikely.
2. Responsibility. If you care about your mobile telephone or laptop computer, you will be more responsible in the ways you use it and handle it. Without being exposed to the risk of losing your mobile telephone (or any other property), carelessness is likely to affect your behaviour.
3. Learning. If we do not make mistakes, how would we be able to learn? Failure is largely a signal that we are missing some important information, assuming sufficient incentives. We learn from failure more than we learn from success.
4. Innovation. With proper incentives and sufficient access to learning, innovation routinely makes success more likely than failure.

One example might elaborate these points. For humans, moving on the ground is much safer, naturally, than flying. Yet, due to incentives, learning, and innovation, travel by air has become much safer than travel by car (ETSC 2003, 12). The fact that air travel was *a priori* more risky led to the surprising result that it is now less risky than travel by cars.

This shows how incentives interact with risk. Learning, innovation, and discipline can reduce the likelihood of failure. In contrast, carelessness and the tendency to gamble can make loss more likely.

3. DEALING WITH RISK

There are in general two approaches for reducing risk:

1. To reduce the likelihood of loss or failure, through learning, innovation, and discipline. This is the primary approach taken by businesses in the real sector, and is a major driver for the technological advancement of our age. According to MacCrimmon and Wehrung (1986) and Shapira (1995), business managers rarely take risk as given. They consistently attempt to adjust risks such that they are confident of a successful outcome.

For some reason, mainstream economics is little concerned with this approach. It is left to engineering and management sciences to figure out how to reduce chances of failure. Instead, economics is mainly concerned with the second approach:

2. To mitigate the *impact* of risk, or the magnitude of the possible loss. This approach, in turn, includes a variety of mechanisms; some belong to the not-for-profit domain, some to the for-profit domain.
   (a) Mutual or cooperative arrangements, in which a members of a group share common risks and help each other to recover possible losses. This obviously is done on a not-for-profit basis, and had been practised since ancient times.

   The other mechanisms belong to the for-profit domain:

   (b) Partnership, whereby risks and returns are shared in certain proportions between two or more partners.
   (c) Diversification, whereby an investor invests his capital in more than one project, to avoid "putting all the eggs in one basket." By diversification, the losses of one investment can be balanced with returns from another.
   (d) Risk transfer, whereby the impact of a given risk is shifted from one party to another, for a fee. This includes commercial insurance as well as derivatives. This mechanism is the one that dominates mainstream finance, and the one mainly studied in mainstream economics.

Risk transfer as such does not reduce the likelihood of loss. It simply shifts the impact from one party to another. In theory, the party taking on the risks should be in a position to manage and mitigate the risks taken on (by diversification through pooling them while avoiding risk concentrations) better than the parties transferring the risks. But nothing in the contract by which risk is transferred specifies or even encourages this theoretical

objective. Derivatives, in particular, impose no requirement on the risk taker, be it a hedge fund, an insurance company, a commercial bank, or any other institution.

In reality, however, risk transfer would negatively affect incentives in a manner that makes failure more likely. Economists are well aware of this effect, widely recognised as "moral hazard." Yet, mainstream economics pays little attention to how likelihood of loss changes due to distorted incentives. Instead, probabilities of failure are assumed to be exogenously fixed, and the task at hand is to derive the optimal allocation and price of risk.

Not only does this approach contradict the way real businesses deal with risk, as pointed out above, but, also, by ignoring the influence of incentives on risk, it might very well lead to higher risks *and* greater losses. Ignoring the feedback effect of incentives on economic variables was one major reason behind the failure of mainstream economics and finance to predict, let alone prevent, the global financial crisis (Al-Suwailem 2012).

The approach taken by Islamic finance towards risk, as we shall see, encompasses both not-for-profit and for-profit arrangements. In the latter domain, precepts of risk require a certain level of responsibility, with sufficient flexibility for various techniques for risk mitigation. This allows Islamic instruments to combine the best of various approaches to risk mitigation, meanwhile avoiding the major pitfalls that lie behind recurrent financial crises.

4. THE FUNDAMENTAL LAW OF RISK

An important regularity concerning risk in economic life has been very well established: the positive relationship between risk and return. The higher the risk of an investment, the higher is its expected return. "The tradeoff between risk and expected return is the most fundamental notion in modern Finance" (Poitras 2010, 44). A 100 percent perfectly hedged investment implies 0 percent return (Francis 1991, 219). Not surprisingly, "nothing ventured, nothing gained" is the first rule in the business game (Bernstein 1996, 256).

This principle implies the following important result.

4.1 Fallacy of Composition

Because risk is inherent in economic activities, it cannot be eliminated from the economy. If all agents wanted to completely avoid risk, the economy simply would come to a halt. No economy can function without risk. This fallacy has an important implication for the conventional means for mitigating risk.

4.2 Risk Concentration

Suppose that, instead of all agents seeking to avoid risk, the majority of them want to do so, and a minority, like Lehman Brothers or the insurance company AIG, are willing to assume this risk. Then risk would become concentrated on this minority. With higher concentration of risks, the overall risk of the system (i.e., systemic risk) becomes higher: A failure of any of these "risk centers" might lead to a cascade of failures, threatening the stability of the entire system.

4.3 Interconnectedness

Concentration of risk creates higher interconnectedness among agents. Agents previously unconnected become now interlinked through these "risk-centres" such as AIG. Furthermore, by shifting the underlying risk to other parties through a contractual obligation, counterparty risk replaces underlying risk. But this does not eliminate the risk, since counterparty risk might be correlated to the risk being hedged, as Max Planck Institute economist Martin Hellwig (1998, 341–342) observes. When too many agents do the same, they necessarily become much more interconnected and interdependent as they become counterparties to each other. Higher correlation can cause the "law of large numbers" to break down and usual hedging arguments to fail (Brock, Hommes, and Wagener 2009).

4.4 Risk and the Global Financial Crisis

The above analysis, to a large extent, has been the case in reality. According to the U.S. Office of Currency Comptroller, five U.S. banks dominate 96 percent of all derivatives trades in the United States (OCC 2011). This has been the case for the past decade. Warren Buffet, in 2003, warned that "large amounts of risk, particularly credit risk, have become concentrated in the hands of relatively few derivatives dealers, who, in addition, trade extensively with one another. The troubles of one could quickly infect the others . . . [and] can trigger serious systemic problems" (Buffet 2003, 14). This was particularly the case with AIG.

During the bubble in the run-up to the global financial crisis, AIG had accumulated huge amount of credit risk, such that the U.S. Federal Reserve had to bail it out by injecting cumulatively more than $180 billion (FCIC 2011, xxv). The chairman of the Federal Reserve, Ben Bernanke, justified the bailout in 2008, saying: "The Federal Reserve took this action because it judged that, in the light of prevailing market conditions and the size and composition of AIG's obligations, a disorderly failure of AIG would have severely threatened global financial stability" (cited in Cassidy 2009, 326).

Interconnectedness was clearly observed prior to the crisis. According to the Turner Review of the U.K. Financial Services Authority, there was "an explosion of claims *within* the financial system" which has "increased the potential impact of financial system instability on the real economy" (FSA 2009, 18). A key driver of this explosion of intra-system activities came from the growth in derivative markets, notes Andrew Haldane of Bank of England (Haldane and May 2011). With greater intrasystem activities, the financial sector becomes increasingly homogenous. Greater homogeneity might make each bank individually safer, but it makes systemic risk much larger (Haldane and May 2011, 353).

4.5 Self-Defeating Strategy

The case of AIG clearly shows that attempts to shift risk on a large scale end up with greater risks, which substantially defeat the objective of such risk-transfer. Almost all of bond insurers went out of business after guaranteeing billions of dollars' worth of subprime debt that soured during the financial crisis (Alloway 2012). The "innovative" instruments created by banks and other financial institutions to trade risks ultimately led to the dangers these instruments were ideally designed to avoid. As University of Chicago professor R. Rajan (2010, 146) points out, "their own collective actions precipitated the events they should have feared." The same was observed in the 1987 stock market crash, which was due largely to derivatives-based "portfolio insurance." What was supposed to be insurance created the very losses it was meant to avoid (Patterson 2010, 61).

4.6 Toxic Assets

Concentration of risk can be most clearly observed in collateralised debt obligations (CDOs). CDOs structure a pool of (for example) home mortgages or loans into tranches, whereby the top tranche is the least affected by defaults, and thus receives a very high (e.g., AAA) credit rating. But this can be done only by concentrating risk on the lowest tranche (junior or "equity"), usually described as "toxic waste" or "nuclear waste" (Partnoy 2003, 386; Morris 2008, 41). The "toxicity" of these tranches, known in advance to be highly risky, was the cost of producing AAA tranches; that is, risk cannot be eliminated but is only shifted from one place to another. But the distribution of risk had changed. Prior to tranching, risk was independently diversified. Through tranching, however, default risk became highly interlinked in order to produce apparently safe and "risk-free" tranches (see Krahnen and Wilde 2006).

4.7 Risk Appetite

Shifting economic risk onto other parties will result in the willingness of the hedged party to take additional risks. The reason is simple: Economic agents (individuals, firms, etc.) in a competitive market are seeking to improve returns. By reducing risk, their capacity to take on additional risks, for the same level of capital, rises. Since risk and returns are positively correlated to generate additional returns, the agent would therefore take on additional risks. The more an agent is able to hedge risks, the more risk the agent becomes willing to take in order to make more returns (Patterson 2010, 97).

Economists W. A. Brock, C. H. Hommes, and F. O. Wagener (2009) argue that, in the presence of hedging instruments, traders will be able to take bigger positions on risky assets because they can hedge away more risk. As more traders follow the same strategy in order to improve their returns, the market becomes exposed to overshooting, and hence market volatility increases. When these bigger positions are financed by debt, higher leverage will amplify risks. The authors conclude that adding more derivatives may destabilise markets, increase volatility, and at the same time decrease welfare.

When the two types of risk (the one hedged, and the one taken) are of a similar nature, we end up with a positive feedback loop: More hedging leads to more risk-taking. The result is higher, not lower, risks. This was clear during the global financial crisis. Banks provided home mortgage finance to customers, and then they purchased credit default swaps (CDSs) on these loans. CDSs work similarly, but not identically, to an insurance device, whereby lenders can shift risk of default to the seller of the CDS. By shifting the risks of these loans, lenders were able to lend even more as they had freed up their capital. As home mortgages expanded, house prices went up. As house prices went up, CDSs became less costly as the perceived risk of default became smaller. With CDSs perceived as safer to their sellers and more affordable to buyers, more mortgage lending was advanced to more risky people, hence pushing house prices higher, feeding another round of the loop. The positive feedback loop created a bubble in housing that ultimately had to explode. CDSs were a major factor that fueled the bubble (FCIC 2011, xxiv).

Credit default swaps, however, differ from traditional insurance in that buyers of CDSs need not have any interest in the referenced loan. In this case, the seller and the buyer are simply betting on whether a certain borrower will default or not. These are called "naked" CDSs. According to the superintendent of the New York Department of Insurance and quoted by Bloomberg news on 2 March 2009, about 80 percent of outstanding CDSs are naked. As the majority of derivatives are side-bets, they act as an amplification mechanism of risk (Das 2009; FCIC 2011, xxiv): Instead of

risk being confined to the two parties of the loan, it is now replicated several times across the financial market. This shows that risk-transfer instruments that are disconnected from the real economy are liable to create more risk rather than contributing to its mitigation.

4.8 Swings in Attitudes towards Risk

Conventional banking has been described as "boring banking" (e.g., Stiglitz 2010, 81). Simply to lend money and to wait to collect more money offers no excitement and imposes minimal challenges. To improve returns, especially in a context of low interest rates and "cheap money," banks were induced to move into more "exciting" and highly risky activities, which were typically speculative and little more than gambling (Dunbar 2011).

But because the shift was not in line with economic fundamentals, banks went from one extreme to the other. The collapse of many banks during the crisis shows how costly this swinging can be. The calls to return to boring banking (e.g., Nocera 2012), would have little appeal to banks, and would be very difficult to implement in practise. What we need is a reasonably "exciting" banking but with sufficiently stable and robust structure. This difficult balance is a distinctive characteristic of Islamic finance.

5. ISLAMIC FINANCE

Principles of Islamic finance revolve around the balanced relationship between risk and return. They establish clearly how risk should be related to returns and ownership. As we shall see, these principles address the challenges arising from complex interactions of risk with economic activities. In addition to prohibition of *riba* (trading money for money), the three most important precepts in Islamic finance governing risk are outlined in the following sections.

5.1 Prohibition of Excessive Risk-Taking and Gambling

Gambling is strictly prohibited in Islamic finance. It is generally characterised as a zero-sum game with uncertain payoffs. *Gharar* is the more general form of risky transaction. It is described as risk in which likelihood of loss is greater than or equal to that of gain (Al-Suwailem 2006). All zero-sum games, in which by definition one party's gain is equal to the counterparty's loss, are not merely risky, but the risk is *unjustified* since there is no creation of economic value.

Holding "naked" positions in assets by means of derivatives[3] (or by "short selling"), a common form of speculation, is a form of gambling, or

maysir. Such activities do not create economic value, and thus belong to the class of zero sum games in economic theory.

5.2 Balance of Rights and Obligations

This principle states that one is entitled to benefits of a certain asset, good, or service, by bearing its physical risk (i.e., risk of damage or loss). Alternatively, being liable for the risk of a particular good or service entitles the agent to its benefits. Entitlement to benefits reflects ownership, and this requires responsibility for loss or damage. In Arabic, this principle is stated as: "*al-kharaj bidhaman*."

This principle imposes a certain degree of symmetry and balance between rights and obligations. Liability cannot be separated from ownership of the related benefits; one cannot (or should not) bear the risk of an object without being entitled to its benefits. Separating the two, therefore, is not acceptable.

5.3 Profits and Liability

The third principle states that profit or return is justified only by ownership of (and liability for) the underlying asset, good, or service. That is, one cannot make profits from trading an asset or a good without being first liable for it as an owner. In Arabic, *ribhu ma lam yudhman* is forbidden. Again, this principle emphasises real ownership; debt trading cannot be a source of profit or return.

Making profits from pure lending violates this principle. A lender who lends $1,000 is shifting the risk of this amount of money to the borrower. Hence, any return arising from using the money in trade or investment belongs to the one who bears the risk of such transactions (i.e., the borrower). Since the lender is shielded from this liability, he is not entitled to any return on the loan. This would simply be *riba*. To earn returns, the financier should finance a trade: to buy a good or service, and then sell it to the customer for a deferred price. The deferred price includes the costs to the financier, including cost of capital. Time value is allowed only in trade, but not in loans. In this manner Islamic finance blocks the road towards self-replication of debt, which leads to detachment of finance from real productive activities.

6. FUNCTIONS OF RISK IN ISLAMIC FINANCE

By balancing risks and benefits of goods and services, Islamic rules of risk provide an environment whereby risk is supposed to perform its social

functions. As pointed out earlier, exposure to risk provides incentives to minimise these risks through learning and innovation. However, exposure to excessive risk is undesirable because the size of the possible loss is such that, if it eventuates, the consequences are likely to be socially harmful.

Severing risk from ownership of the underlying good or service allows risk to multiply independent of the real economy, as is the case with CDS and derivatives, which can be contracted several times more than the underlying asset.

Severing risk from ownership of the underlying good or service also distorts incentives, leading to the well-known problem of moral hazard, whereby insured parties have the incentive to abuse the insured good for their own benefit at the expense of the insurer. Moral hazard leads to more risk taking, not lower risk. In the presence of moral hazard, markets are "incomplete," and in this case, risk transfer may in fact increase risk concentration (Krahnen and Wilde 2006).

Commercial insurance shifts risks in respect of a certain good from the owner to the insurance company, in return for a fee. The insurer becomes liable for losses in respect of the good without being entitled to its benefits. This makes rights and obligations unbalanced, which is inconsistent with principles of *Shari'ah*. This imbalance leads to adverse selection and moral hazard due to insufficient incentives and deficiency in responsibility. Because of moral hazard and adverse selection, the insurance market ceases to be efficient, and "optimality will not be achieved either by the competitive system or by an attempt by the government to simulate a perfectly competitive system," as Nobel laureate Kenneth Arrow remarks (Arrow 1971, 220). Moral hazard, according to Arrow, is the most important factor explaining the limitations of insurance as a mechanism for risk shifting (1971, 141); under full insurance, "productive activity and risk-bearing can be divorced," but such system is "bad because it reduces (or distorts) incentives" for risky enterprises (138, 143). Another aspect of the problem of moral hazard in insurance is that the insurer is, in a sense, *speculating* that the insured loss will not occur. The insured thus faces the moral hazard of the insurer finding some specious excuse in order to avoid paying a valid claim.

One alternative to commercial insurance is *takaful*, or mutual cooperative insurance, which in principle replaces commercial (i.e., for-profit arrangements), by not-for-profit alternatives. Instead of replacing ownership with counterparty risk as in commercial insurance, members of *takaful* pool their risks that are to be insured and make contributions to the risk pool so that valid claims may be paid. The risk pool and the assets financed by its funds belong to the members; hence the moral-hazard problems of commercial insurance are largely mitigated.[4]

7. RISK EXCHANGE IN ISLAMIC FINANCE

Precepts of risk in Islamic finance do not imply that risk cannot be managed. While for-profit risk transfer is not in principle permitted, risk *exchange* is acceptable as an inseparable part of a real transaction. Unlike conventional risk-transfer (mainly through derivatives) that involves zero-sum transactions, risk exchange is achieved through mutually beneficial transactions. In this manner Islamic instruments allow for managing risk without falling into zero-sum activities.

Integrating risk with ownership of the underlying good or service provides a set of incentives to manage the risk appropriately and, subsequently, to allocate resources productively. Since Islamic instruments in general involve real exchange of goods or services, as one kind of risk is shifted to one party, a *different* kind of risk is being taken up by the hedged party. The same gain-from-trade therefore applies to risk exchange in this case. The reason is that, contractually, risk is integrated with ownership of goods and services, and thus, trade of these implies trade of associated risks. Just as trade promotes specialisation and therefore productivity with respect to traded goods or services, exchange of associated risks should achieve the same objectives with respect to risk.

In this manner, risk exchange is unlikely to lead to the destabilizing effects resulting from derivatives. The reason is that as one form of risk is shifted, a different form of risk is assumed. Further, risk exchange would restrict the positive feedback of the kind observed during the credit bubble that ended in the global financial crisis. Furthermore, since risk exchange is contractually in tandem with real economic activities, this greatly limits concentration of risk that might arise from instruments like CDSs. Integration of risk and real ownership of the related benefit imposes specialisation in risk taking, and this promotes diversification of risk rather than its concentration. The real economy, by nature, is diversified. Given that risk in Islamic finance is integrated with trade and economic activities, this means that risk becomes diversified as well.

As the studies of the IMF (2007, 2009a) and of Reinhart and Rogoff (2009) have shown, risks of the real economy have been much lower than the financial sector. Hence, integrating finance with the real economy results in lower overall risks. Accordingly, technological advances in the real economy could greatly help reduce risks in the financial sector provided that the latter remains anchored in the real economy.

Because profits cannot be made in Islamic finance without assuming ownership risks of the underlying good or service, there is an upper bound on risk-shifting to other agents, and thus to interconnectedness (risk

correlations) among these agents. Furthermore, the restrictions on debt (prohibition of *riba* and debt-trading) encourage greater ownership and higher levels of equity. Equity and equity-type instruments play a vital role in the economy, as discussed later.

From an Islamic finance point of view, the swing from "boring banking" to "exotic derivatives" reflects the imbalance between risk and return. By integrating finance with real economic activities, Islamic finance strikes a balance between risks and returns: banks and financial institutions are able to improve returns and satisfy preference for venturing without being involved in speculative bubbles and wealth-destroying activities.

Furthermore, by integrating risk with real economic activities, both dimensions of risk, likelihood of loss and magnitude of loss, can be substantially reduced. Only after having sufficient incentives for learning and discipline could diversification be of added value. Otherwise, the false sense of security arising from shifting risk to others might deteriorate incentives, leading ultimately to higher, not lower, risks, as discussed earlier.

Overall, an effective strategy to contain and control risk is to have it integrated and embedded within real activities. In this manner, risk becomes naturally controlled by the real economy. Meanwhile this would generate sufficient net wealth or equity in order to compensate for such risks. This strategy therefore helps to achieve the two objectives at once: creating wealth and minimizing risk.

8. REGULATORY IMPLICATIONS

The most important lesson of the global financial crisis, and most previous financial crises, is that pure self-interest in profit-seeking markets is likely to result in a devastating impact on the economy at large. In contrast to the assumptions behind mainstream neoclassical economics, it needs to be recognised that self-interest alone cannot produce the common good for all. Externalities and endogenous instability prove the need for proper coordination and cooperation to maintain stability without jeopardizing productivity.

Regulation alone cannot achieve these objectives. Without ethical and moral commitment, any set of legal or regulatory requirements can be evaded or circumvented. Any legal system is only very partially effective without ethics and morality on the part of individuals and decision makers. The Financial Crisis Inquiry Report, prepared by the U.S. Congress in 2011 to investigate the causes of the crisis, concludes that, "there was a systemic breakdown of accountability and ethics" (FCIC 2011, xxii). Ethics must be an integral part of all regulations, particularly those that pertain to the financial sector.

8.1 Stability is a Collective Endeavour

Regulations aim to achieve social objectives that serve the interest of all members of the society. In the case of financial regulations, the most important of these objectives is economic stability. As many writers have observed, stability is a public good (e.g., IMF 2009b, xxii): It requires the collective efforts of economic agents to be achieved. Attempts to improve individual returns at the expense of the society will end up in losses to all. This is most clearly conveyed in the saying of Prophet Mohammad, peace be upon him:

> *The example of those abiding by Allah's order in comparison to those who violate them is like the example of those persons who drew lots for their seats in a boat. Some of them got seats in the upper part, and the others in the lower. When the latter needed water, they had to go up to bring water (and that troubled the others), so they said, 'Let us make a hole in our share of the ship (and get water) saving those who are above us from troubling them.' So, if the people in the upper part left the others do what they had suggested, all the people of the ship would be demolished, but if they prevented them, both parties would be safe.*
>
> **Sahih al-Bukhari (no. 673)**

A single person might easily cause the ship to sink, but to navigate the ship safely to the shore requires a team of fully coordinated sailors. Stability will be undervalued by private institutions, notes the IMF (2009b) report, and regulations are needed to internalise the costs of instability.

8.2 Finance Should Not Be a Zero-Sum Game

Banks need to internalise social responsibility and not to focus on purely material self-interest. But this should not be only rhetoric. As the saying goes, "the devil is in the details." Hence, to internalise social responsibility, finance must be contractually integrated with real, productive, activities. Chairman of the Financial Stability Board, Mark Carney, in an interview, insists that banks "must be forced to serve the real economy" (Masters 2012). Severing finance from the real economy not only defeats the function of finance as a means to achieve economic prosperity, but also makes finance necessarily a zero-sum game.

The financial sector can create net wealth by channeling resources to productive and socially desirable activities in the real economy, and by permitting the sharing of risks to facilitate enterprise within the real economy. While it may appear that wealth is being created within the financial

sector, if there is no counterpart within the real economy, this wealth proves to be spurious, as gains are recognised while losses (such as asset impairments) remain concealed until after bubbles have burst.

This implies that, for Islamic banks, products designed to end up in pure financing (like organised *tawarruq* and *einah*), using redundant commodities that add no economic value, should be greatly restricted. These instruments decouple finance from productive activities. Further, regulators should provide incentives for financial institutions to better integrate financing with real activities, without jeopardizing the soundness and safety of these institutions.

8.3 Over-Aversion to Risk Makes It More Likely

Regulators used to insist on highly rated or highly "safe" investments for banks or other regulated financial institutions. This might make these banks individually safer. But, at the macro level, this might lead to risk concentration, as we have seen earlier. These risks will simply move from the regulated institutions to unregulated ones. The result is concentration of risk without supervision or transparency. The system therefore becomes more risky and fragile, without regulators knowing about it.

To prevent this kind of regulatory arbitrage, and to upgrade "microprudential" policy to "macroprudential" perspective, regulators should place more emphasis on proper measures and procedures to be used by banks and regulated financial institutions, rather than solely focusing on the credit rating of the customer or investee. Furthermore, financial institutions of various segments should participate in a kind of mutual insurance to contain risks they jointly face. By applying this requirement to all financial institutions, regulated or not, incentives for regulatory arbitrage would be greatly reduced.

8.4 Leverage Is Dangerous

In the aftermath of the collapse of the hedge fund Long Term Capital Management (LTCM) in 1998, President George W. Bush of the United States formed the President's Working Group on Financial Markets to examine the causes of the collapse and provide recommendations (WGFM 1999). In the cover letter, the report states:

> *The principal policy issue arising out of the events surrounding the near collapse of LTCM is how to constrain excessive leverage. By increasing the chance that problems at one financial institution could be transmitted to other institutions, excessive leverage can increase the likelihood of a general breakdown in the functioning*

of financial markets. This issue is not limited to hedge funds; other financial institutions are often larger and more highly leveraged than most hedge funds.

Leverage can be reduced by encouraging equity and equity-like instruments. Equity acts as an economic shock absorber, and successfully works as a circuit breaker in case of financial panics. Credit linkages can easily spread the shock and lead to contagions. Equity helps to absorb the shock and to arrest the contagion in its early phases. Collectively, the wealth of the society comes down to its total equity; claims against other agents cancel each other out. The higher the level of equity, therefore, the more net wealth the society has.

The perception that "equity is more expensive" is largely misplaced. It has been generally acknowledged in the wake of studies published by economists Modigliani and Miller (1958, 1963), that equity is more expensive than debt only when the market is distorted by factors such as more favourable tax treatment of debt. More recently, Stanford University professor of finance Anat Admati and her colleagues refute the claims that "equity is expensive" and that high capital requirements would affect credit markets adversely. Admati and her co-authors (2011) have called the arguments advanced to support the proposition that equity is more expensive than debt "fallacious, irrelevant, or very weak." Further, they point out that policies which subsidise debt and indirectly penalise equity, through taxes and implicit guarantees, are distortive. Setting equity capital requirements significantly higher than the levels currently proposed, they suggest, would entail large social benefits and minimal, if any, social costs.

Regulators are aware of the importance of equity, and accordingly, the minimum capital levels set out in Basel III are significantly higher than those in Basel II. In addition, there is more insistence on the loss absorbency of components of regulatory capital.[5]

Since risk sharing is considered to be highly desirable in Islamic finance, regulators should allow for profit-and-loss-sharing instruments on both sides of the balance sheet of Islamic banks, but with proper systems and procedures in place. This might require a kind of separation between deposit-taking and investment functions, as in "narrow banks" (Kay 2009) and "limited-purpose banking" (Chamley and Kotlikoff 2009).

Instead of credit-worthiness rating, profit sharing requires fiduciary-capacity and business-worthiness rating. With such procedures properly in place, profit sharing should improve both stability and profitability of Islamic financial institutions. To encourage equity-like instruments, the bias towards debt financing in laws and regulations must be substantially reduced, if not totally eliminated (FAD 2009).

9. CONCLUSION

Risk does not disappear by a mere transfer from one party to another. While diversification and related techniques can greatly mitigate the impact of risk, risk as such (i.e., likelihood of failure), can be reduced only by learning and technological advancement that make safety and success substantially more likely. But this requires a proper set of incentives, which in turn requires exposure to these risks. Exposure to ownership risk induces incentives for learning and innovation that would make everyone better off. Risk trading through gambling-like instruments, in contrast, will make the system more risky and make large-scale losses more possible. They defeat the very purpose they are created for.

Islamic finance provides a framework for balancing the relationship between risk and returns. While the framework is conceptually appealing, it requires careful and proper implementation to be practically relevant. At a time when the world is looking for a paradigm change in the global economy, as Jean-Claude Trichet (2009), then president of the European Central Bank, remarks, the Islamic financial industry bears a great responsibility to contribute to the new paradigm and the sought-after global financial stability.

NOTES

1. The views expressed in this chapter are those of the author, and do not necessarily reflect the position of the Islamic Development Bank. Special thanks to Rifaat Ahmed Abdel Karim and Simon Archer for their helpful and constructive comments. All infelicities are the responsibility of the author.
2. This likelihood need not be quantifiable or follow a well-defined probability distribution.
3. For example, a "naked" put option is a put on an asset that the buyer of the put does not hold, while a "naked" call is a call on an asset that the seller of the call does not hold.
4. For practical issues related to *takaful*, see Archer, Karim, and Nienhaus (2009).
5. See Archer and Karim (2012).

REFERENCES

Admati, A., P. DeMarzo, M. Hellwig, and P. Pfleiderer. 2011. "Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity is *Not* Expensive." Working Paper no. 86, Stanford University.

Alloway, T. 2012. "Goldman Looks to Monoline Insurance Move." *Financial Times*, March 18.

Al-Suwailem, S. 2006. "Hedging in Islamic Finance." Occasional paper no, 10, Islamic Research and Training Institute IRTI), Jeddah, Saudi Arabia.

Al-Suwailem, S. 2012. "Complexity and Endogenous Instability." *Research in International Business and Finance*, Available online 21 August 2012, ISSN 0275–5319, doi:10.1016/j.ribaf.2012.08.002.

Archer, S., and R.A.A. Karim. 2012. "The Structure, Regulation and Supervision of Islamic Banks." *Journal of Banking Regulation* 3: 1–13.

Archer, S., R.A.A. Karim, and V. Nienhaus, eds. 2009. *Takaful Islamic Insurance: Concepts and Regulatory Issues*. Singapore: John Wiley.

Arrow, K. 1971. *Essays in Risk Bearing*. Chicago: Markham Publishing Company.

Aziz, Z. A. 2010. *Islamic Finance and Global Financial Stability*, www.ifsb.org/docs/IFSB-IRTI-IDB2010.pdf.

Bernstein, P. 1996. *Against the Gods*. New York: John Wiley & Sons.

Bookstaber, R. 2007. *A Demon of Our Own Design*. Hoboken, NJ: John Wiley & Sons.

Brock, W., C. Hommes, and F. Wagener. 2009. "More Hedging Instruments May Destabilise Markets." *Journal of Economic Dynamics and Control* 33: 1912–1928.

Buffet, W. 2003. "Letter to Shareholders." *Annual Report 2002*, Berkshire Hathaway Inc.

Cassidy, J. 2009. *When Markets Fail*. New York: Farrar, Straus and Giroux.

Chamley, C. and L. Kotlikoff. 2009. "Limited Purpose Banking: Putting an End to Financial Crises." *Financial Times*, The Economists' Forum, January 27.

Das, S. 2009. "Credit Default Swaps and Amplified Losses." *Financial Times*, March 04.

Dunbar, N. 2011. *The Devil's Derivatives*. Cambridge, MA: Harvard Business Review Press.

European Transport Safety Council (ETSC). 2003. *Transport Safety and Performance in the EU: A Statistical Overview*. Brussels: European Transport Safety Council.

Fiscal Affairs Department (FAD). 2009. "Debt Bias and Other Distortions: Crisis-Related Issues in Tax Policy." Fiscal Affairs Department, IMF.

FCIC. 2011. *Financial Crisis Inquiry Report*. National Commission on the Causes of the Financial and Economic Crisis in the United States, www.fcic.gov.

Francis, J.C. (1991) *Investments: Analysis and Management*. New York: McGraw-Hill.

Financial Services Authority (FSA). 2009. *The Turner Review: A Regulatory Response to the Global Banking Crisis*, www.fsa.gov.uk/pubs/other/turner_review.pdf.

Haldane, A. and R. May. 2011. "Systemic Risk in Banking Ecosystem." *Nature* 469: 351–355.

Hellwig, M. 1998. "Banks, Markets, and the Allocation of Risks in an Economy." *Journal of Institutional and Theoretical Economics* 154: 328–345.

International Monetary Fund (IMF). 2007. *World Economic Outlook*, October.

International Monetary Fund (IMF). 2008. *World Economic Outlook*, October.

International Monetary Fund (IMF). 2009a. *World Economic Outlook*, April.

International Monetary Fund (IMF). 2009b. *Global Financial Stability Report*, April.

Kay, J. 2009. "Should We Have Narrow Banking?" In *The Future of Finance: The LSE Report*, edited by Adrian Turner et al. London: London School of Economics and Political Science.

Krahnen, J., and C. Wilde. 2006. "Risk Transfer with CDOs and Systemic Risk in Banking." Frankfurt, Germany: Centre for Financial Studies.

Kumar, M. 2008. *Quantum*. New York: W. W. Norton & Co.

MacCrimmon, K. and D. Wehrung. 1986 *Taking Risks: The Management of Uncertainty*. New York: Free Press.

Masters, B. 2012. "FSB Chief Call to Rein in 'Shadow Banking.'" *Financial Times*, January 15.

Modigliani, F. and M.H. Miller. 1958. "The Cost of Capital, Corporation Finance and the Theory of Investment." *American Economic Review* 48 (3): 261–297.

Modigliani, F. and M.H. Miller. 1963. "Corporate Income Taxes and the Cost of Capital: A Correction." *American Economic Review* 53 (3): 433–443.

Morris, C. 2008. *The Trillion Dollar Meltdown*. New York: Public Affairs.

Nocera, J. 2012. "Make Banking Boring." *New York Times*, May 14.

Office of Comptroller of the Currency. 2011. *OCC Bank Derivatives Report*, First Quarter.

Partnoy, F. 2003. *Infectious Greed*. New York: Henry Holt & Co.

Patterson, S. 2010. *The Quants*. New York: Crown Business.

Poitras, G. 2010. *Valuation of Equity Securities*. Hackensack, NJ: World Scientific Publishing.

Rajan, R. 2010. *Fault Lines*. Princeton, NJ: Princeton University Press.

Reinhart, C. and K. Rogoff. 2009. *This Time is Different: Eight Centuries of Financial Folly*. Princeton, NJ: Princeton University Press.

Shapira, Z. 1995. *Risk Taking: A Managerial Perspective*. New York: Russell Sage Foundation.

Stiglitz, J. 2010. *Freefall*. New York: W.W. Norton & Co.

Trichet, J.-C. 2009. "A Paradigm Change for the Global Financial System." Speech delivered at the International Colloquium "Nouveau Monde, Nouveau Capitalisme" roundtable, Paris, January 9.

(WGFM). 1999. "Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management." Report of The President's Working Group on Financial Markets, Board of Governors of the Federal Reserve System, United States.

CHAPTER 5

Capital Structure and Risk in Islamic Financial Services

Simon Archer and
Rifaat Ahmed Abdel Karim

1. INTRODUCTION

In general, the role of equity capital in firms is to absorb unexpected losses, expected losses being covered by provisions that are liabilities. In addition to equity capital, other forms of financial instruments may serve to absorb losses, notably preferred shares and convertible or subordinated debt. The essential role of such capital is the protection of creditors of the firm, making it creditworthy or solvent.

The capital structure of financial services firms such as banks and insurance undertakings, and in particular the proportion of equity capital in their capital structure, is subject to regulation, with particular reference to its ability to absorb losses without these being passed on to depositors (in the case of banks) and policyholders (in the case of insurance undertakings). "Capital adequacy" of banks is a key concern of regulators and supervisors in view of the systemic risk of contagion within the banking sector; if depositors lose confidence in the solvency of one institution and withdraw their funds, this tends to have "knock-on" effects on other banks, which can result in a banking crisis such as that experienced following the collapse of Lehman Brothers in 2008. (The failure of Lehman Brothers, however, was symptomatic rather than a cause of that crisis.)

In the case of insurance undertakings, there is not the same exposure to withdrawals of deposits as there are in banks, but in addition to the concern for policyholder protection there is a risk of cross-sectoral knock-on effects—for example, where banks hold credit default swaps issued by an

Islamic Finance: The New Regulatory Challenge.
Edited by Simon Archer and Rifaat Ahmed Abdel Karim
Copyright © 2013 by John Wiley & Sons Singapore Pte. Ltd.
ISBN: 978-1-118-62897-3

insurance undertaking that is unable to honour them (as in the case of AIG in 2008).

The more risky the assets held by a firm, the more "risk absorbent" capital it requires to remain solvent. Hence, the regulatory regimes for banks and insurance undertakings typically take account of the riskiness of their assets in determining their capital requirements. In the case of banks, the Basel Accords employ "risk weightings" of assets. Insurance undertakings and their supervisors also need to consider the riskiness, or susceptibility to estimation error, of insurance liabilities (technical provisions), as in the European Union's risk-based capital regime known as Solvency II (see Smith 2009).

Both Islamic banks and Islamic insurance (*takaful*) undertakings have, in their different ways, specific characteristics as regards both asset risk and capital structure, which differentiate them from their conventional counterparts. It is these characteristics and their implications that form the subject matter of this chapter. Section 2 concerns Islamic banks, while Section 3 addresses *takaful* undertakings. The final section sets out some concluding remarks.

2. RISK AND CAPITAL STRUCTURE IN ISLAMIC BANKS

Asset risk in Islamic banks differs from that in conventional banks because the assets held by the former comply with *Shari'ah* requirements to avoid interest, and also because some of the risk management (hedging) tools used by conventional banks do not meet *Shari'ah* requirements. Thus, Islamic financing assets are based on (a) exchange transactions involving non-financial assets, (b) forms of leasing contracts, or (c) forms of partnership. These forms of contract allow the Islamic bank to earn an interest-free return on funds. They also entail, to varying degrees, asset or market risk associated with the assets involved in the exchange or leasing contracts, or the particular form of credit risk arising from the provision of financing on a partnership basis (where the financier has no debt claim on the party being financed). In addition, Islamic banks are exposed to specific forms of operational risk. Consequently, Islamic banks need to hold capital against these market risks and operational risks.

2.1 Market Risk Exposures on Islamic Financing Contracts

Different types of market risk exposures have varying effects. This section examines examples from Islamic financing contracts involving exchange transactions, lease-to-buy contracts, and partnerships.

Exchange Transactions Examples of market risk exposures resulting from exchange transactions in the course of Islamic financing contracts are given below. These exposures may be mitigated in various ways, but subject to that they give rise to a need for capital as set out in the Basel 1996 Market Risk Amendment.

***Murabahah* Financing** The *murabahah* contract is used in credit sale transactions, in which the bank acquires ownership of the asset which its customer wishes to buy and then sells it to the customer on credit. Prior to the credit risk exposure following the sale, this transaction exposes the bank to market risk on the asset as an item of inventory while it is in the bank's ownership. This is illustrated in Exhibit 5.1, which is taken from the IFSB's capital adequacy standard.

***Salam* Financing** The *salam* contract is used particularly in providing financing to producers of commodities in the form of crops or livestock. The bank pre-purchases and pays for a specified quantity and quality of the commodity, for a specified delivery date, at which time the bank will sell the commodity hoping to do so at a higher price. The bank is thus exposed to market risk on the commodity from the time of pre-purchase until disposal.

Islamic Lease-to-Buy Contracts Islamic banks use the *ijarah muntahia bit-tamleek* (IMB), a form of lease-to-buy contract, to finance the acquisition by

EXHIBIT 5.1 Credit and Market Risk Weights for *Murabahah* with No Binding Agreement to Purchase from the Customer

Applicable Stage of the Contract	Credit Risk Weights (RW)	Market Risk Capital Charge
1	Asset available for sale (asset on bank's balance sheet)	15% capital charge (= 187.5% RW)
2	Asset is sold, title is transferred to customer, and the selling price (account receivable) is due from the customer	Based on customer's rating or 100% RW for unrated customer
3	Maturity of contract term or upon full settlement of the purchase price, whichever is earlier	Not applicable

customers of assets, both residential real estate and chattels such as vehicles. The bank first acquires the asset and then leases it to the customer, with a promise to transfer full ownership of the asset to the customer at the end of the lease. This may be done either on payment of a token amount by the customer, or by a gradual transfer of ownership *pro-rata* the lease payments over the life of the lease. The lease payments are thus composed of two elements: a pure rental element and a capital element whereby the customer builds up equity in the asset. The bank as lessor is exposed to market risk on the asset, in the first place between the time of acquiring the asset and the signature of the lease agreement, and thereafter on its ownership share of the asset until the customer becomes the outright owner. In addition, the bank is exposed to the credit risk of the lessee, and because of its ownership of the asset until its title is transferred to the lessee, the bank is exposed to operational risk.

Partnership Forms of Financing The most common form of partnership contract used for financing is the diminishing *musharakah*, in which the bank and the customer jointly own (initially) the asset which the customer wishes to buy, with the bank usually having the major share. The customer agrees to purchase the bank's share over time by making periodic payments, and, in the case of home purchase for example, to pay rental amounts to the bank for the right to use the share of the asset still in the bank's ownership. The bank is exposed to market risk on this share—see Exhibit 5.1.

2.2 Capital Impairment Risk on Partnership Forms of Financing

Where financing is provided to a customer on the basis of a partnership agreement, such financing does not give the bank a debt claim that could be enforced in case the customer fails to make a scheduled payment. The bank's claim is to its ownership share of the partnership asset. This exposes the bank to impairment of the capital it has invested in the financing arrangement that is different type from normal credit risk. The bank is also exposed to the credit risk of the customer failing to pay the lease rental. The Islamic Financial Services Board's (ISFB's) capital adequacy standard treats this exposure as a type of "equity position risk in the banking book," which attracts a substantially higher risk weighting than a normal receivable.

2.3 Summary of Asset-Side Risk Specificities and Capital Implications

As indicated above, several forms of Islamic financing expose the financier to market risk, in addition to credit risk. On the other hand, the asset-based nature of such financing makes it easy for the financier to mitigate the credit

risk by taking a lien on the asset in the case of *murabahah*, or by exercising ownership rights in the case of IMB. Also, the market risk exposure in *murabahah* is typically of very short duration and may be mitigated by requiring a deposit from the customer to discourage nonperformance of the agreement to purchase. Hence, with the exception of financing based on partnership forms of contract, one cannot conclude that Islamic financing is more risky for the financier, and requires more capital to back it, than conventional debt-based financing, with the proviso that the different risk mitigation techniques it calls for are competently applied.

2.4 Profit-Sharing Investment Accounts and Displaced Commercial Risk

Islamic banks typically use a form of profit sharing (and loss bearing) investment accounts (PSIA) as a *Shari'ah*-compliant alternative to conventional deposit accounts. These accounts are based on the *mudarabah* contract or, more rarely, on the *wakalah* contract. In either case, the bank is not liable for losses on the assets financed by these accounts except in the case of "misconduct and negligence" (i.e., breach of the fiduciary duties of integrity and due diligence). In the case of *mudarabah*, the bank as *mudarib* (fund manager) receives a contractually agreed share of any profits earned on the investment, while in *wakalah* the bank as *wakeel* receives a fixed management (agency) fee and in some cases an additional performance-related fee. Unrestricted PSIA (UPSIA) funds are invested at the bank's discretion and are typically commingled with other funds under the bank's control, such as those of current accounts as well as shareholders' funds.

Holders of UPSIA usually have the right to withdraw their funds at relatively short notice, subject to forfeiting any profit share for the current period. This can expose the bank to "withdrawal risk" if the returns it pays on these accounts cease to be competitive. This may occur if the bank faces "rate-of-return risk," an analogue of the conventional "interest rate risk in the banking book." To mitigate withdrawal risk, an Islamic bank may be under pressure to pay returns on its UPSIA in excess of the returns that are attributable to them from those on the underlying assets. To do this, the bank may need to reduce its share of profits or fee, or even donate part of the share that is attributable to the shareholders. This pressure gives rise to displaced commercial risk (DCR), as a part of the credit and market risk of the assets financed by UPSIA is effectively displaced onto the shareholders.

As a result of DCR, an Islamic bank may need to hold capital against assets financed by UPSIA funds, even though *contractually* it has no exposure to such assets. In its capital adequacy standard, the IFSB designates the proportion of such assets (on a risk-weighted basis) against which capital

should be held, in recognition of DCR, as *alpha*. Thus, in calculating the capital adequacy ratio of an Islamic bank, the denominator of the ratio will include the proportion *alpha* of such assets, where applicable.

2.5 Capital Structure of Islamic Banks

Islamic banks are not permitted to issue preferred shares or subordinated debt, so that their capital consists of common equity with the possible addition of innovative, and so far rarely used, types of *sukuk* (Islamic investment certificates) based on the *musharakah* contract. Some of the latter may be contingently convertible into common equity, while others may have features such that they rank after creditors and UPSIA. These latter *sukuk* are not subordinated in the normal sense of representing creditor claims that rank after those of other creditors (which would not be *Shari'ah* compliant), but the holders are in a contractual relationship with the bank, which gives them a *residual* claim over the assets financed by their funds that ranks after those of the bank's creditors and UPSIA. Thus, the claims of the *sukuk* holders are *effectively* "subordinated" to those of creditors and UPSIA. Such *sukuk* are referred to in this chapter as "effectively 'subordinated' sukuk." In the case of contingently convertible or effectively subordinated *sukuk*, in order to qualify as regulatory capital under Basel III (either additional Tier 1 or Tier 2), they must meet stringent criteria of loss absorbency.

UPSIA are not part of an Islamic bank's regulatory capital. While they are loss absorbent, the loss absorbency relates only to the assets financed by their funds. Technically, according to the International Accounting Standards Board's International Accounting Standard 32, *Financial Instruments: Presentation*, they are "puttable instruments" and are classified as liabilities, although their only claim (absent "misconduct or negligence" on the part of the bank) is for the net asset value, after losses, of the assets financed by their funds. However, UPSIA may be used as a form of leverage by Islamic banks, which can leverage up their income stream by raising UPSIA and taking a substantial percentage of the profits earned from investing their funds. Some degree of DCR may result from this, but apart from DCR the UPSIA are something of a "free lunch" for Islamic banks from a capital point of view.

In addition, recently some Islamic banks have started the practice of raising short-term funds in the form of deposits based on reverse commodity *murabahah* transactions (CMT). This enables them to take term deposits, which are repayable with a *murabahah* mark-up on maturity. These are obviously not part of regulatory capital, and indeed are a source of risk for the bank since the risks of the assets financed with such deposits (both credit and market risk, and also liquidity risk) have to be borne entirely by the bank. Unlike that of UPSIA, which are typically used as savings accounts, and like

conventional deposits, CMT-based deposits have an effective liquidity in practice that is lower than their contractual liquidity. The effective liquidity of CMT-based deposits is the same as their contractual liquidity, which entails refinancing risk if the credit needs to be rolled over. This can contribute to liquidity crises such as that which affected the Islamic investment bank Arcapita in 2012.

2.6 Capital Adequacy

The IFSB has set out a standard, based on adaptations of the Basel Accords, for Islamic banks, including:

- Eligible capital.
- Risk weightings for Islamic financing assets, taking into account market as well as credit risk.
- The treatment of assets financed by PSIA and of DCR in the calculation of the capital adequacy ratio.
- The treatment of operational risk.

The IFSB proposes that Islamic banks, which typically lack the credit risk data necessary to implement the internal ratings–based (IRB) risk weightings on assets, should use the standardised approach with standard risk weightings.

Like the Basel Committee, the IFSB has no authority to impose this standard, this being the role of national regulatory and supervisory authorities. In line with Basel III, Islamic banks will be required to hold Core Tier 1 (i.e., common equity) equal to 4.5 percent of risk weighted assets (RWA), and Total Tier 1 (including additional Tier 1 instruments such as *musharakah sukuk* that meet the criteria for "going concern capital") equal to 6 percent of RWA. The minimum total capital requirement remains at 8 percent of RWA, and the additional 2 percent may be met by Tier 2 instruments such as convertible or effectively subordinated *sukuk* having a sufficiently high degree of risk absorbency and other characteristics so as to meet the criteria for "gone concern capital" "Going concern capital" consists of instruments that absorb losses while the bank is still solvent, while "gone concern capital" is composed of instruments that absorb losses only upon the bank's insolvency.

In addition to this minimum capital requirement, the IFSB follows Basel III in specifying a "capital conservation buffer" of 2.5 percent of RWA, consisting of common equity capital. The total capital requirement will thus be 10.5 percent, including 6 percent of common equity. If an institution's regulatory capital falls below this level, but still meets the minimum of 8 percent, the supervisor will impose restrictions on capital distributions (dividends and repurchases of common equity shares) until the capital

conservation buffer is restored to the required level. Finally, the Basel Committee has specified an extension of the "capital conservation buffer" in the form of a "counter-cyclical buffer" of up to a further 2.5 percent of RWA, again consisting of common equity capital. The purpose of this counter-cyclical buffer is to mitigate the macroprudential problem of cyclicality in the banking system, which manifests itself in buoyant asset values and capital levels in periods of economic expansion, and shrunken asset values and capital levels in periods of contraction, thus aggravating the economic cycle. The IFSB has proposed that the implementation of this counter-cyclical buffer be at the discretion of national supervisory authorities

2.7 Summary

For Islamic banks, capital structure and risk are linked, from a regulatory perspective, via risk weightings and capital requirements set out by the IFSB based on the Basel III Accords and the standardised approach to risk weighting. The minimum capital level obtained by applying this approach is not necessarily a measure of the economic capital that the bank should hold to provide an adequate buffer against unexpected losses. Indeed, the aim of the IRB approach was to bring regulatory capital closer to economic capital. However, the capital conservation buffer provides a mechanism that enables the supervisory authority to oblige a bank to increase its capital if the level is too close to the minimum.

3. RISK AND CAPITAL STRUCTURE IN *TAKAFUL* (ISLAMIC INSURANCE) UNDERTAKINGS

The capital structure of *takaful* undertakings is complicated by their hybrid structure and business model. The *Shari'ah* requires insurance to be undertaken on a mutual basis, so that the risk funds are owned by the policyholders, as are the investment funds in life or "family" *takaful*. On the other hand, many countries do not recognise mutual or cooperative forms of company, so that the mutual structure needs to be contained within that of a company limited by shares. Moreover, in most if not all jurisdictions, insurance solvency regulations impose capital requirements that a *new* mutual or cooperative insurance undertaking would be unable to meet. (Archer, Karim, and Nienhaus 2009). Mature mutual insurers were able to build up the necessary reserves over decades prior to the introduction of such regulation, but *takaful* undertakings have not had the time to do this.

3.1 Capital Structure, Risk, and Ancillary Capital

For the reasons given above, the typical structure of a *takaful* undertaking is that of a limited company with share capital and reserves, together with one

or more funds that belong to the policyholders but are attached to the company by contracts (*wakalah* or *mudarabah*) under which the company as *takaful* operator (TO) manages the underwriting, investment, and associated activities on behalf of the policyholders. The TO thus performs the functions carried out by the management of a mutual insurer, but its board of directors is accountable to its shareholders and not to the policyholders. The policyholders' funds are included in the balance sheet of the *takaful* undertaking, much as the investment account holders' funds appear in the balance sheet of an Islamic bank.

The regulatory capital of a *takaful* undertaking thus needs to meet the solvency requirements of the insurance operations, and the TO also needs capital to cover its own business risks, especially the risk of its management fees being insufficient to cover its operating expenses and the "underwriting management risk" potentially arising from failure in its fiduciary duties in managing the underwriting of the policyholders' risk fund (PRF). The solvency requirements of the insurance operations concern the underwriting risk of the risk fund or funds (provisioning risk, or the risk of underestimating the amounts needed as technical provisions) and the asset risk of the assets held in these funds. However, as noted above, in general the *takaful* risk funds (PRF) do not contain sufficient reserves (policyholders' equity) to meet the solvency requirements.

The TO is not permitted by the *Shari'ah* to take on the underwriting and asset risks of these funds, but may provide a form of capital backing in the form of an interest free loan (*qard*) facility which is available to be drawn down into a risk fund in case the latter is unable to meet its obligations (i.e., is in deficiency), and which would be repayable out of future underwriting surpluses. Subject to certain conditions, such a loan facility may qualify for recognition as "ancillary capital" (as defined in Solvency II) and thus enable the *takaful* undertaking to meet regulatory solvency requirements. (See the IFSB *Standard on Solvency Requirements for Takaful (Islamic Insurance) Undertaking*—IFSB 2010). Hence, the TO needs to hold capital and an amount of sufficiently liquid assets to back the *qard* facility.

Exhibit 5.2 illustrates this point. The abbreviations are defined here: PRF (policyholders' risk fund), PTC (prescribed target capital [of the TO]), MTC (minimum target capital), PCR (prescribed capital requirement [of the PRF]), and MCR (minimum capital requirement [of the PRF]). Thanks to the "Notional Assets" pertaining to *qard*, the PRF meets the PCR and there is even a bit of excess. Strictly speaking, as the *qard* is a loan, the right to call it (the *qard* facility) does not increase the net assets of the PRF from an accounting perspective, but provided it meets the criteria for ancillary capital, it is treated as doing so from a regulatory perspective.

Where a *qard* facility is required to enable a PRF to meet its solvency requirement, it should generally be set up at a value that will provide some

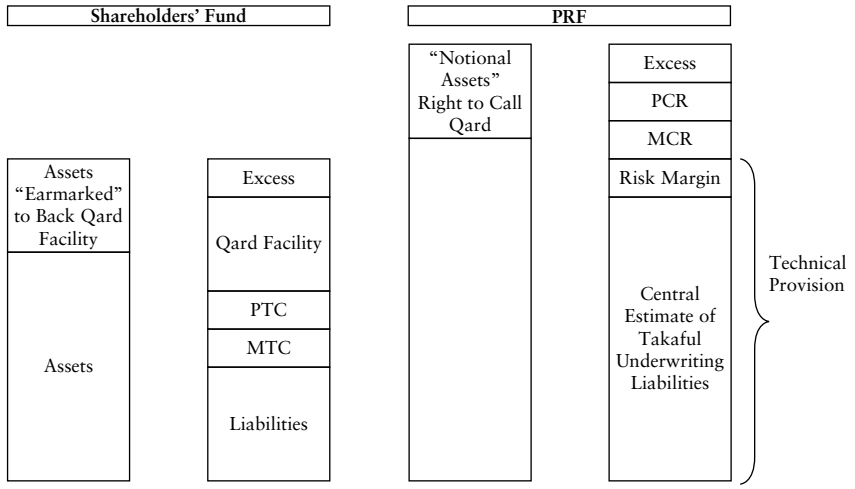


EXHIBIT 5.2 General Approach to the Solvency and Capital Requirements for a *Takaful* Undertaking, where the PRF Relies on a *Qard* Facility to Meet Solvency Requirements

Source: IFSB Standard.

buffer over and above the minimum solvency requirement. This is to allow the PRF to meet its requirements on a continuous basis notwithstanding reasonably foreseeable fluctuations in asset and liability valuations. The assets backing a *qard* facility should be "earmarked" for this purpose. That is, they should be specifically identified and held in a discrete account separately from other assets in the shareholders' fund. In assessing the adequacy of a *qard* facility for solvency purposes, the supervisory authority should look through to the earmarked assets as regards adequacy of amount and degree of liquidity.

3.2 Reinsurance via Re-*Takaful*

A *takaful* undertaking may reduce its need for capital (as well as for technical provisions) by ceding business, especially of a "high impact low frequency" nature, to a *Shari'ah*-compliant reinsurer or re-*takaful* undertaking. This will, however, expose the *takaful* undertaking to credit risk in respect of receivables that may become due from the re-*takaful* undertaking.

3.3 Summary

The total capital of a *takaful* undertaking consists of (a) the policyholders' equity in the PRF and (b) the TO's capital and reserves. The latter are divided into the amount available to meet the TO's own need for risk capital, and the

amount available to provide ancillary capital to the PRF in the form of a *qard* facility. For the *takaful* undertaking to satisfy regulatory solvency requirements, this latter amount, in conjunction with the policyholders' equity, must enable the PRF to meet its prescribed capital requirement.

Since TOs are not permitted to issue preferred shares or subordinated debt, a TO's capital consists of common equity. In principle, a TO could also issue forms of *sukuk* that provide adequate loss absorbency, but so far this does not appear to have happened.

4. CONCLUDING REMARKS

It will be apparent from the sections in this chapter that the capital structures of both Islamic banks and Islamic insurance undertakings present complexities not found in the case of conventional financial institutions. In the case of Islamic banks, a major complexity is introduced by the presence of unrestricted PSIA (UPSIA), which are profit sharing and loss bearing but not part of the bank's own capital, and which are liable to be a source of displaced commercial risk for the bank. For Islamic insurance undertakings, their hybrid business model, with mutual risk funds contractually attached to a limited company, the TO, coupled with the lack of the equity in the risk funds required to meet regulatory solvency requirements, results in a complex capital structure wherein the TO (which is not permitted by the *Shari'ah* to take on underwriting risk) provides a *qard* facility to the risk fund. If certain conditions are met, the *qard* facility can act as auxiliary capital for regulatory purposes.

So far as risks are concerned, Islamic financing assets typically involve market risk as well as credit risk exposures. This clearly affects Islamic banks, but insofar as Islamic insurance undertakings hold such assets, the same applies to them.

REFERENCES

Archer, S., R.A.A. Karim, and V. Nienhaus, eds. 2009. *Takaful Islamic Insurance: Concepts and Regulatory Issues*. Singapore: John Wiley & Sons [Asia] Pte.Ltd.

International Accounting Standards Board. 2011. International Accounting Standard 32, *Financial Instruments: Presentation*, latest revision. London: International Accounting Standards Board.

Islamic Financial Services Board (IFSB). 2010. *Standard on Solvency Requirements for Takāful (Islamic Insurance) Undertakings*. Kuala Lumpur: Islamic Financial Services Board.

Smith, J. 2009. "Solvency and Capital Adequacy in *Takaful*." In *Takaful Islamic Insurance: Concepts and Regulatory Issues*, edited by S. Archer, R.A.A. Karim, and V. Nienhaus. Singapore: John Wiley & Sons [Asia] Pte. Ltd.

CHAPTER 6

Inherent Risk: Credit and Market Risks

John Lee Hin Hock

1. INTRODUCTION

Islamic finance has grown significantly since its rise to prominence in the last decade, with a growing number of countries adopting Islamic finance as the emblem of their financial services sector. The prominence received a further boost with the global financial crisis, when doubts were cast on the role of the conventional financial system in financial intermediation insofar as it was evident that the conventional financial system increasingly was decoupled from the "real" economy.

Nonetheless, while the interest in Islamic finance has grown, the management of the risks inherent in the operation of Islamic financial institutions (IFIs), particularly relating to specificities of *Shari'ah*-compliant products and services, is still relatively new and developing. Although some progress has been made through the establishment of Islamic finance risk and governance frameworks, advances in the area of risk management for Islamic finance have not kept pace relative to the growth of the industry.

The chapter explores the risk specificities of *Shari'ah*-compliant products and services, particularly the credit and market risks of these products and services.

2. DISTINCTIVE RISKS

IFIs are faced with risks that are distinct from those of their conventional counterparts. The tenets of Islamic finance are based on the conformity to *Shari'ah* law, which is the juristic code of Islam based on the Qur'an and the

Islamic Finance: The New Regulatory Challenge.
Edited by Simon Archer and Rifaat Ahmed Abdel Karim
Copyright © 2013 by John Wiley & Sons Singapore Pte. Ltd.
ISBN: 978-1-118-62897-3

hadith, and forbids certain practices that are common in conventional finance. It is this distinction that gives rise to the contrasting risk profiles between conventional and Islamic finance products and services.

IFIs are bound by:

- The prohibition of speculation (*maysir*) and of the receipt and payment of interest (*riba*).
- The need to avoid uncertainty *(gharar*) or highly uncertain financial transactions.
- The prohibition of the financing activities that are themselves prohibited (*haram*).
- The principles of promotion of fairness in transactions and the prevention of exploitative relationships.
- The requirement to honour contracts.
- The principle of sharing risks and rewards between the principals in a transaction.
- The requirement that transactions should carry elements of materiality, which lead to tangible economic purpose.

As a result, *Shari'ah* compliant products and services have distinct and different risks from conventional finance products and services. An example of the differences between the financial risks arising from an IFI's products as compared to conventional finance can be seen when considering the concept of risk sharing. In the case of a financial product such as home purchase financing plans structured on the basis of the diminishing *musharakah* concept (a type of partnership), the IFI takes joint ownership of the asset, and is faced with market risks should the counterparty default and the price of the asset fall below market value, which is not the case for conventional mortgages. This is illustrated in Exhibit 6.1.

Home Financing Islamic versus Conventional Finance

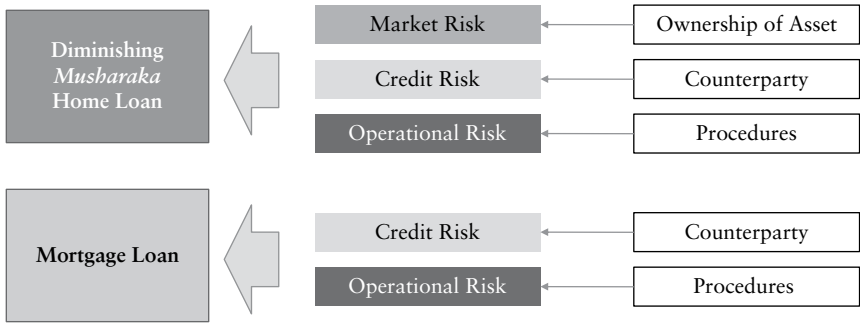


EXHIBIT 6.1 Unique Islamic Risk

To understand the unique nature of the risks of *Shari'ah*-compliant products and services, it is important to understand the structure of these products and services. The different structures used could lead to distinct and different risk profiles.

3. INHERENT RISKS IN *SHARI'AH*-COMPLIANT PRODUCTS AND SERVICES

Shari'ah-compliant products and service involve inherent risks, including credit, market, and displaced commercial risk, as described next.

3.1 Credit Risk

The risk of counterparties not fulfilling predetermined obligations is not so dissimilar for IFIs compared to conventional financial institutions. An IFI deals with counterparties who at the onset agree to meet the stipulated terms of repayment. However, there is the potential that these counterparties may not meet these terms.

Credit risk exposures for IFIs result from, but are not limited to:

- Accounts receivable in *murabahah* contracts.
- Accounts receivable and counterparty risk in *istisna'a* contracts.
- Counterparty risk in *salam* contracts.
- Equity investment risk in *musharaka* contracts.
- Lease payments receivable in *ijarah* contracts.

3.2 Market Risks

Market risk is the risk of losses in on- and off-balance sheet positions arising from market prices. Conventional financial institutions are exposed to these risks from the positions they hold in financial instruments. These positions are held, amongst other objectives, intentionally to secure a short-term profit from price or interest-rate variations, or to hedge against other elements of the trading book.

However, due to the unique nature of the IFIs' way of doing business, speculative transactions and contracts connected to the incidence or non-incidence of future events are prohibited. This includes conventional derivatives and some other hedging transactions. While IFIs are therefore not exposed to speculative market risks, this does not limit their exposure to other market risks, some of which are unique to the IFIs due to the manner in which contracts are required to comply with *Shari'ah* principles concerning the materiality of transactions and the sharing of risk and rewards. As a

result, IFIs carry out multiple asset-based transactions in which they take ownership of physical assets in the course of a financing transaction (such as a credit sale or a lease-to-buy purchase), which exposes them to market risk associated with the price of these assets.

3.3 Displaced Commercial Risk

The notion of displaced commercial risk is peculiar to IFIs, and arises mainly from fluctuations in the rate of return required by profit-sharing investment account (PSIA) holders. Fluctuations in the rate of return oblige IFIs to increase the rate given to their PSIA holders in order to retain their funds in the institution. Thus, an IFI may have to give up a portion of its share of profits as *mudarib* (i.e., manager), normally allocated to the IFI's shareholders. This is illustrated in Exhibit 6.2.

Displaced commercial risk arises through rate of return risks; when PSIA funds are placed in assets such as *murabahah* with long-term maturities, the rates of return on which are no longer competitive with alternative investments. Although in theory IFIs are not obliged to provide smoothing of income to the PSIA holders (due to the nature of risk sharing), supervisory authorities and commercial pressures may in fact oblige them to do so.

Because the nature of Islamic finance is governed by the rules and principles of the *Shari'ah*, the following premises add a unique dimension to risk management in an IFI's operations:

- The role of IFIs in *mudarabah* and *musharakah* financing, whereby the IFI takes on the risk of not receiving payment from the other party or finding itself potentially liable for taking delivery of an asset.
- The commencement of credit risks that underlie various financing modes vary according to the recognition of the binding or nonbinding nature of some contracts (e.g., *murabahah*) or the transformation of a customer's *mudarabah* or *musharakah* investment into a debt in case of proven negligence or misconduct of the IFI as *mudarib* or *musharakah* managing partner.
- The prohibition of penalties to be imposed in certain contracts, except in the case of deliberate procrastination, which reduces the IFI's ability to use guarantees as risk mitigants to protect it against capital impairment.
- In addition, the restrictions on the use of conventional derivatives and the limited availability of *Shari'ah*-compliant derivatives, which limit the IFI's ability to manage its balance sheet and liquidity as thoroughly and effectively as conventional banks do.

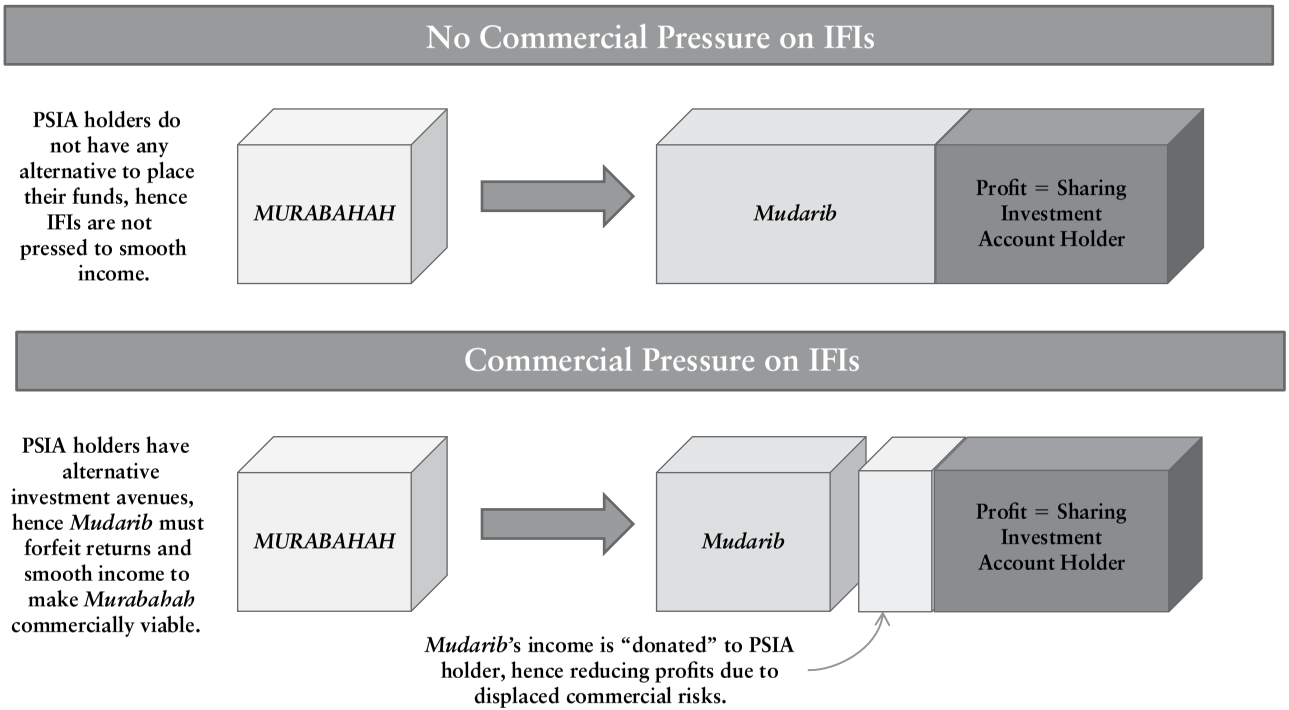

No Commercial Pressure on IFIs
PSIA holders do not have any alternative to place their funds, hence IFIs are not pressed to smooth income.
MURABAHAH
Mudarib
Profit = Sharing Investment Account Holder
Commercial Pressure on IFIs
PSIA holders have alternative investment avenues, hence Mudarib must forfeit returns and smooth income to make Murabahah commercially viable.
MURABAHAH
Mudarib
Profit = Sharing Investment Account Holder
Mudarib's income is "donated" to PSIA holder, hence reducing profits due to displaced commercial risks.

EXHIBIT 6.2 Displaced Commercial Risk

Since IFIs employ a number of structures, the review of inherent risk in IFIs requires the risk assessment process be structured in a matrix format. For each structure, the initial step would be to review each stage on one side and exposure to credit and market risks on the other side. The high-level overview of inherent credit and market risk exposures in a number of *Shari'ah*-compliant products and services are provided in the Appendix. Note that the IFIs are also exposed to other risks, such as operational and liquidity risks, this article considers only credit and market risks.

4. CONCLUSION

Risks are inherent in the operations of both Islamic and conventional financial institutions. Although the risk exposures of a conventional financial institution are somewhat different from those of an IFI, the main principles of risk management still apply.

However, Islamic risk management sophistication has to be product driven. Even though as a matter of economic substance *Shari'ah*-compliant products and services may closely resemble their conventional counterparts, they may nevertheless have distinct and different risk profiles.

The tenet of Islamic finance that encourages the sharing of risk and reward between the principals in a transaction has yet to be fully realised. This aspect of Islamic finance seems most promising as a clear differentiator of Islamic finance from conventional finance.

APPENDIX

Exhibits A.1 to A.6 show a high-level overview list of inherent credit and market risks associated with different *Shari'ah*-compliant products and services.

EXHIBIT A.1 *Murabahah* for the Purchase Orderer (MPO)

Stage	Application and Principles	Credit Risk	Market Risk
Agreement to purchase (AP)	A customer enters into a verbal agreement or memorandum of understanding (agreement to purchase, or AP) with an IFI requesting the IFI to purchase a specified type of good with an agreement to repurchase. The AP specifies: detailed description of the good(s); units desired; and supplier (this is optional). The AP can be binding or nonbinding depending on the views of the *Shari'ah* board.		
	Principal and Agent Relationship The IFI obtains price quotations from suppliers or appoints a purchasing agent (agent). The IFI executes an agency contract with the agent.		
	The goods must be purchased from a third party and not from the customer or his agent/company. However, the goods can be purchased from a party who has a blood/marital relationship with the customer.		***Price Risk (nonbinding MPO)*** If customer cancels the AP, the IFI has to sell the goods in the open market at a selling price that can be lower than the purchase price. The IFI may require/intensify marketing efforts to sell the

(*Continued*)

EXHIBIT A.1 (*Continued*)

Stage	Application and Principles	Credit Risk	Market Risk
	The offer for sale by the supplier (can be in the form of an invoice) must be addressed to the IFI and a sale is concluded once the offer is accepted by the IFI. The supplier delivers goods to the IFI. The IFI takes possession or "constructive possession" of the goods and subsequently offers goods for sale to customer. The contract cannot stipulate that the ownership of the goods be transferred upon full payment of the selling price. A constructive possession can take place by, *inter-alia*, having the goods placed at the IFI's disposal, receipt of bill of lading by the IFI or its agent, or receipt of certificates of storage issued by warehouse. The IFI is responsible for the risks associated with the goods and is liable for any defects from this point onwards.		cancelled purchase goods (low asset price). Alternatively, IFI has to hold the goods and incur additional cost such as warehousing, insurance, or even damages (if the goods are perishable in nature). *Risk Mitigation* *The IFI can purchase goods on "sales return" basis.* *IFI can request for* hamish jiddiyyah *or security deposit. This is normally required in the case of a binding promise.*

Asset is sold and delivered to a customer	The IFI and customer execute a *murabahah* contract if the customer agrees to purchase the goods. The following *Shari'ah* principles must be met for the contract to be valid: the goods are in existence at the time of sale; ownership of goods must be with the seller/IFI; the goods are in possession or constructive possession of the seller/IFI; the goods must have a commercial value; the goods are not to be used for a *haram* purpose; the goods must be specifically identified and known; the delivery of goods is certain and not conditional upon certain event; and the selling price is fixed at cost plus mark-up or profit.	***Settlement Risk/Default Risk*** Customer may not be able to honour the payment (loss of receivables). *Risk Mitigation* *IFI may request for* urboun, *a third-party financial guarantee or pledge of assets.* *Direct debit from customer's account, centralised blacklisting system, and penalty help to deter the customer's late payment behaviour. Some* Shari'ah *scholars consider charging compensation fee.*
Maturity of contract term	The customer settles the full amount of selling price to IFI.	

EXHIBIT A.2 *Salam* (and Parallel *Salam*)

Stage	Application and Principles	Credit Risk	Market Risk
Payment of purchase price	The customer as the seller and IFI as the buyer execute a *salam* contract or a *Salam* Master Agreement (to be followed by execution of multiple *salam* contracts). Contract is binding and cannot be cancelled unilaterally. The contract specifies: type of good to be delivered by customer or *al-muslam fihi*; quantity; date, place, and manner of delivery; basis for determining the price; and mode of payment.		***Commodity Price Risk*** Salam is a forward purchase of goods. Upon signing the contract, IFI is exposed to price risk of goods (low asset value). *Risk Mitigation* *IFI enters into a* parallel salam.[1]
	Payment of Salam Capital IFI pays capital of *salam* to the seller/customer when the contract is executed. Some *Shari'ah* scholars allow a delay of payment by two to three days after the contract date. The capital of *salam* can be in the form of cash, fungible goods, or usufruct. For *salam* capital in the form of fungibles the agreement must specify its kind, type, specifications, and quantity.	***Settlement/Delivery Risk*** Goods are not delivered or not delivered on time or not according to specification by the seller/customer after payment is made (loss of invested amount). *Risk Mitigation* *IFI may request a performance guarantee from customer to give assurance on the delivery of goods or a pledge of goods.*	

Receipt of the purchased goods	Goods delivered that are not within the specifications can be rejected by the IFI.[2] If the seller cannot deliver goods due to insolvency, the seller can be granted an extension of delivery. Cancellation of delivery of goods is allowed in return for repayment of *salam* capital on portions that are yet to be delivered.	***Capital Recovery Risk*** The *salam* capital cannot be recovered fully; or claims against *urboun* or a financial guarantee are not sufficient to cover for the whole amount of *salam* capital (loss of invested capital).	***Asset Replacement Risk*** (for *salam* with parallel *salam*) IFI has to purchase goods from open market in order to meet its delivery obligation under parallel *salam*. IFI is exposed to higher price.
Maturity of contract term	Customer delivers goods of specified kind and quality to the IFI on the agreed date.[3]		***Commodity Price Risk*** (*salam* without parallel *salam*) Upon receiving the goods, the IFI is exposed to price risk of goods (low asset value).

EXHIBIT A.3 *Istisna'a* and Parallel *Istisna'a*

Stage	Application and Principles	Credit Risk	Market Risk
Contract (during the period of unbilled work-in-process)	The IFI executes an *istisna'a* contract with the manufacturer (subcontractor) requesting the latter to construct or manufacture a specified type of goods. The contract specifies: type of goods to be manufactured/ constructed; price (that can be paid fully in advance, in deferred instalments or upon full completion); date, place and manner of delivery; and mode of payment (cash, tangible goods or usufruct of an asset for a specified duration).	***Settlement Risk*** Customer in parallel contract is unable to honour the payment for deferred instalment or progress billing (loss of amount of receivables). *Risk Mitigation* *IFI may secure* urboun *or money in advance prior to commencing the work.* ***Completion Risk (Istisna'a)*** When an advance payment been made by IFI, the subcontractor does not complete work (and situation worsened if no other subcontractor to replace) and in turn poses some risks to parallel *istisna'a* ***Recovery Risk*** Capital is irrecoverable from the subcontractor. *Risk Mitigation* *IFI can secure a performance guarantee from subcontractor.*	***Price Risk (of Cancelled Ordered Goods)*** If the customer of parallel *istisna'a* cancels the contract, IFI continues to pay for the manufacture of the goods till completed and sell to a third party at a price that may be lower than the original contract price (loss of asset value)[4] *Risk Mitigation* *IFI may request* urboun, *which can be deducted from the selling price if the contract is fulfilled or forfeited if the contract is rescinded.* *IFI may enter into parallel* istisna'a.[5]

	Goods delivered that are not within the specifications can be rejected by the buyer or be accepted by the buyer as it is, with or without a price discount. If goods delivered are within specifications or of higher quality, the buyer is obliged to accept unless a higher price is demanded by the seller (in the case of higher quality of goods being delivered). If the goods are ready but the buyer delays in taking delivery, the goods in the possession of the IFI will be on a trust basis and the IFI is not liable for any loss or damages unless at the negligence and misconduct of the IFI.
Maturity of contract term	The subcontractor (on behalf of the IFI) delivers completed goods to the final customer. When the final customer delays in taking delivery of the completed goods, the IFI can sell the goods to a third party to recover its contract price and return the balance if any or have a recourse against the buyer if not sufficient.

EXHIBIT A.4 Operating *Ijarah* and *Ijarah Muntahia Bittamleek* (IMB)

Stage	Application and Principles	Credit Risk	Market Risk
Agreement to lease (AL) (binding)	When a customer requests IFI (the lessor) to purchase a specified asset. A customer enters into a memorandum of understanding (agreement to lease or AL) with an IFI requesting the IFI to purchase a specified kind of asset with a promise to lease. The IFI should first purchase the asset prior to execution of an *ijarah* contract.		
	The IFI takes possession or "constructive possession" of the assets and subsequently offers the asset for lease to customer. IFI is responsible for the risks associated with the asset.		***Price Risk*** When the customer opts not to fulfil the promise or agreement to lease, the IFI has to lease (or sell) at lease rentals (or a selling price), which can be lower than the original total rentals (or selling price) to the original customer (low asset value). *Risk Mitigation* *IFI requests for* hamish jiddiyyah, *or security deposit, to guarantee the customer's commitment to lease the asset. The IFI can deduct the difference between the total lease rentals (or a selling price to a third party) and cost of the asset when customer breaches the AL.*

Upon consigning a leasing contract.	The customer (as lessee) executes an *ijarah* contract with an IFI (as lessor) requesting the lessor to: acquire an asset, or acquire the usufruct of an existing assets, which the customer wishes to take on lease. The contract can be drawn via a master agreement (to be followed by execution of multiple confirmations of offer and acceptance of individual *ijarah* transactions) or individual contracts. Contract is binding and cannot be cancelled unilaterally. The lease period should commence from the date of execution unless the parties agreed on a specified future commencement date (future *ijarah*). Future *ijarah* is allowed provided that the lease rentals are payable by the lessee after the leased asset is delivered to the lessee. The contract should specify: transfer of the usufruct to the lessee for an agreed period at an agreed consideration;	***Settlement Risk*** Customer is unable to service the lease rental as and when it falls due. This inability can be due to variable lease rentals that may distress the customer's ability to pay. (loss of rental receivables) *Risk Mitigation* *IFI can request for* urboun *from customer and deduct for damages. The* urboun *can also be taken as an advance payment of lease rental.* Alternatively, the IFI as the owner has the right to repossess the assets.	***Benchmark Risk*** Long-term *ijarah* with fixed rental is susceptible to changes in market conditions, e.g., higher return demanded by investors (low investment return). *Risk Mitigation* *Renewable short term leases with price re-fixing subject to mutual consent,* *or the adoption of variable lease rentals, which are determined according to a certain benchmark.*

(*Continued*)

EXHIBIT A.4 (*Continued*)

Stage	Application and Principles	Credit Risk	Market Risk
	the leased asset must have a valuable use; the leased asset must be fully identified by the contracting parties; the purpose or intended use of the leased asset by the lessee must be lawful/*Shari'ah*-compliant and in normal course of utilisation (purpose which is not within the normal course requires consent of the lessor); and the lease rental must be determined at the time of contract for the whole period of lease.		
Maturity of contract term.	The asset is returned to the IFI. In the case of IMB, the lessor is unilaterally binding to transfer ownership in the leased asset to the lessee. The option to transfer of legal title / ownership of the leased asset must be documented separately from the *ijarah* contract and be effected via one of the following methods: gift; token consideration; and final instalment of lease rental.		***Residual Value Risk*** (operating *ijarah* only) The IFI will bear the potential loss due to the fair value of the asset falling below its residual value estimated at lease inception (low fair value).

EXHIBIT A.5 *Musharakah*

Stage	Application and Principles	Credit Risk	Market Risk[6]
Contract.	The partners execute a partnership (*musharakah*) agreement that specifies: offer and acceptance; contracting parties; capital amount and structure; and profit-sharing ratio (the ratio can be amended from time to time).		
	Capital The capital can be in the form of cash, gold, silver, or their equivalent in value and tangible assets. Debt (receivables) alone is not permissible as the capital unless the debt is inseparable from other assets that can be presented as a contribution to the capital. Funds in current account can be withdrawn as contribution to the capital. A partner cannot guarantee the capital of another partner.	*Capital Impairment Risk* The *musharakah* capital may not be recovered as it ranks lower than debt instruments upon liquidation. *Risk Mitigation* *A third-party guarantee can be obtained for the loss of capital of some or all partners provided that:* *the legality and financial liability of the guarantee is independent from the contract;* *the guarantee is not linked in any manner to the contract;* *the third-party guarantor should not own more than 50% equity in the entity to be guarantee; and* *the guaranteed entity should not own more than 50% in the guarantor.*	

(*Continued*)

EXHIBIT A.5 (*Continued*)

Stage	Application and Principles	Credit Risk	Market Risk[6]
	Management The management of the *musharakah* can be restricted to certain partners or a single partner. A fixed remuneration to such 'managing' partner(s) is not allowed but the partner(s) can earn a greater allocation of profit share at a ratio higher than its share of capital. A manager other than the partner(s) can also be appointed to manage the *musharakah* at a fixed remuneration and a profit share, if any.		
	Profit-Loss Sharing The profit allocation is calculated net of operating costs, expenses, and taxes. The profit allocation can be equal to the invested capital ratio or different as agreed between the partners, provided that the "sleeping partner" is not entitled to more than its invested capital ratio. The profit share cannot be stated in a lump sum or a percentage of the capital. The profit will be finally allocated from the proceeds of selling existing assets (actual valuation) or based on valuation of assets at fair value (constructive valuation). The allocation of profits must be based on actual profit. Profits can be carried forward and set aside, subject to the provisions of articles of association of the *musharakah*, as reserves.		

	The loss shall be borne periodically by the respective partners in accordance with their contribution of capital. It is not permitted to hold one partner or a group of partners liable for the entire loss or liable for a percentage of loss that does not match their share of ownership. However, a partner can take responsibility to bear the loss at the time of the loss without any prior condition.	
Early termination	A partner can anytime withdraw from the partnership by giving notice to this effect unless in the contract it has explicitly stated that the partnership is to survive for a fixed period whereby termination prior to the agreed expiry date of the *musharakah* is not allowed. The partners can unanimously agree to terminate it prematurely. The withdrawal of a partner does not necessitate the termination of the whole partnership. A partner can enter into a binding promise to buy at any time, all assets of the *musharakah* based on market value as at the acquisition date. **Diminishing *Musharakah*** A partner is allowed to give a promise to buy the equity share of the other partner gradually until the title to the equity is completely transferred.	***Counterparty Risk*** Occurs when the withdrawing partners owes monies to IFI (loss of invested capital). *Risk Mitigation* *The IFI is able to buy into the withdrawing partner's share or to find a new partner to take over.*

(*Continued*)

EXHIBIT A.5 (*Continued*)

Stage	Application and Principles	Credit Risk	Market Risk[6]
	This promise must not be stated in the *musharakah* contract and must be stated in a separate buying and selling agreement.		
Maturity of the contract term	On maturity, the assets are liquidated (sold) or by way of constructive liquidation (valuation). The assets shall be sold at current market values and the proceeds will be utilised for payments in the following order: liquidation expenses; financial liabilities from the net assets; and distribution of the remaining assets among the partners in accordance with the invested capital ratio, or if they fall short, on the *pro-rata* basis to the invested capital ratio.		

EXHIBIT A.6 Mudarabah

Stage	Application and Principles	Credit Risk	Market Risk
Contract	The customer and IFI as partners can establish a *mudarabah* contract via execution of a: memorandum of understanding (MOU), which is to be followed by execution of multiple *mudarabah* contracts; or *mudarabah* contract. The MOU states: intended mode of financing, i.e., restricted or unrestricted *mudarabah* financing instrument; profit-allocation ratio; and type of guarantee that shall be presented by the *mudarib* to cover losses arising from negligence, misconduct, or breach of contract. Contract is nonbinding and can be terminated unilaterally except in the following situations: when the *mudarib* has already commenced the business; and/or when the duration for which the contract is to remain in operation has been determined.		

(*Continued*)

EXHIBIT A.6 (*Continued*)

Stage	Application and Principles	Credit Risk	Market Risk
	Capital The *mudarabah* capital must be in the form of cash or tangible assets that are valued by the experts. The capital cannot be in the form of debt owed by the *mudarib* or another party to the capital provider. The capital must be freely accessible to the *mudarib*/customer for the *mudarabah* contract to be valid. A *mudarib* invests the *mudaraba* capital on a trust basis; hence, it is not liable for losses except in cases of misconduct, negligence, and breach of the terms of the *mudarabah* contract whereby the *mudarib* becomes liable for the amount of the capital. ***Profit Allocation*** The profit allocation ratio and its calculation methodology must be clearly stated. The profit ratio must be on the basis of an agreed percentage of the profit and not in a lump sum or a percentage of the capital. However, the lump sum profit is allowed when both parties agreed in the contract to distribute a lump sum profit if it exceeds a certain ceiling of profit.	***Capital Impairment Risk*** Loss-making operations may require additional capital injection, exposing the IFI to the risk of capital erosion and the opportunity to reinvest in other type of partnerships or investments.	

The profit allocation ratio should be determined when the contract is concluded and the ratio can be changed anytime.

The *mudarib* cannot earn a fee in addition to the profit. Any fees to be earned must be on activities that are not by customer part of *mudarabah* operations and must be executed in a separate agreement. The *mudarib* is not allowed to make a loan, gift or donations out of the *mudarib* funds. The *mudarib* is entitled to claim for travelling expenses based on standard practice or expenses up to the amount allowed by the capital provider.

Profit can only be claimed when the *mudarabah* operations make profit. Any losses must be compensated by profits of future operations. If the losses are greater than profits at the time of liquidation, the net loss must be deducted from the capital, which is solely borne by the capital provider.

If the *mudarib* commingles its own funds with the *mudarabah* funds, the profit earned on both funds shall be divided proportionately to the amounts of the two funds. The *mudarib* may also combine the *mudarabah* funds with *musharaka* funds or accept funds

(*Continued*)

EXHIBIT A.6 (*Continued*)

Stage	Application and Principles	Credit Risk	Market Risk
	from a third party on *mudarabah* basis, subject to the capital provider's permission or by appointment.		
Early termination	Termination can be done by either party (as it is a non-binding contract), or mutual agreement, when Mudarabah funds have been exhausted or suffered losses, upon death of the *mudarib*, or liquidation of the *mudarib*.		
Maturity of the contract term	Interim profits can be distributed on account as long as the *mudarabah* operations are profitable or subject to actual valuation or construction valuation for the final distribution. The final allocation of profit can be based on the selling price of *mudarabah* assets (actual valuation) or valuation of assets on the fair value (constructive valuation), whereby receivables are valued at cash equivalent or net realisable value (i.e., net of a provision for doubtful debts).		

NOTES

1. IFI can sell goods to a party other than the *salam* customer (or a company, which is owned less than a third by the *salam* customer). The parallel *salam* contract must be independent of Salam contract. An IFI's obligation to deliver goods under parallel *salam* is not inter-conditional on the performance obligations under direct *salam* contract.
2. If goods delivered are within specifications or of higher quality, the IFI is obligated to accept unless the seller (in the case of higher quality of goods being delivered) demands a higher price.
3. The IFI may decide not to sell the goods immediately upon receipt; hence, the goods will be exposed to selling-price fluctuations.
4. Cancellation of contract is allowed as long as the IFI has not commenced work and, hence, the IFI is not exposed to price risk.
5. The IFI may enter into a parallel *istisna'a* contract with a final customer (off-taker) to take delivery of the goods ordered (alternatively, the IFI may enter into an *istisna'a* with a view to taking possession of the asset on completion). The IFI may be required to give a guarantee to the subcontractor. The parallel *istisna'a* contract must be independent of the *istisna'a* contract. IFI assumes the liability of ownership risk plus maintenance and insurance expenses.
6. The types of underlying assets of *musharakah* may give rise to market risk.

CHAPTER 7

Operational Risk Exposures of Islamic Banks

Simon Archer and
Abdullah Haron

1. INTRODUCTION

Following the downturn of the financial markets in 2008, the Basel Committee on Banking Supervision (BCBS) has been striving to refine the rules for global financial services. A significant number of financial institutions, especially those classified as SIFI (systematically important financial institutions) had crossed the boundaries of risk taking. In the case of a few of them, their eventual failure posed systemic risks to the world economy, necessitating intervention by governments. As a result, international standard-setting organisations have been working to put in place a new set of regulations to govern financial markets more effectively. One of the most notable efforts made by the BCBS is the introduction of a set of guidelines known collectively as Basel III. At the same time, the Islamic Financial Services Board (IFSB) has formed several working groups with the aim of complementing this work of the BCBS, with regard, for instance, to liquidity risk management, stress testing, and revised requirements for capital adequacy and the supervisory review process.

While Basel III focuses on regulating solvency and liquidity to ensure sufficient capital to return funds to depositors and to be able to survive a protracted liquidity stress situation, the regulations come with some expected changes with respect to the way the institutions operate, a number of which this chapter strives to highlight. In addition, the chapter seeks to explain how the IFSB will adapt such requirements for the application by Islamic banking institutions, with particular reference to operational and related risks.

Islamic Finance: The New Regulatory Challenge.
Edited by Simon Archer and Rifaat Ahmed Abdel Karim
Copyright © 2013 by John Wiley & Sons Singapore Pte. Ltd.
ISBN: 978-1-118-62897-3

Like Basel II, Basel III did not make any distinction between how operational risk is defined and measured. The changes expected as a result of the Basel III requirements and the IFSB future standards will require Islamic banks to re-examine their processes and procedures.

In Basel II, operational risk is defined as "the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events . . . [including] legal risk . . . but [excluding] strategic and reputational risk." Legal risk, in turn, is defined as including, without being limited to, "exposure to fines, penalties, or punitive damages resulting from supervisory actions, as well as private settlements."

Cases of operational failures in the financial services industry brought operational risk to attention as an important area for regulation. The operational failures manifested themselves in different activities of these institutions, including failure in risk oversight by senior management, and poor accounting and auditing processes.

Basel II introduced a capital charge for operational risk, using a methodology described below. However, the use of a capital charge for this purpose is somewhat controversial. A major reason for this is that the nature of operational risk is such that measuring it for capital adequacy purposes is problematic.

2. BASEL III REQUIREMENTS AND THEIR IMPLICATIONS FOR OPERATIONAL RISK MANAGEMENT

The proposed new regulations on the banking sector, known as Basel III, will improve global financial stability. However, a by-product of the regulation will be the adoption of tighter credit conditions for certain business activities. Banks will have to comply gradually with the new, stricter rules, as the full implementation of Basel III is not expected before 2019. Nevertheless, banks need to be aware of the risks implicit in the context of operations.

2.1 New Capital Buffer

Basel III requires a minimum level of common equity (Common Equity Tier 1 or CET1) set at 4.5 percent, a the total Tier 1 capital requirement of 6 percent, and a total capital requirement (Tiers 1 and 2) of 8 percent, with an additional 2.5 percent capital conservation buffer (CCB) consisting of common equity in addition to CET1. Thus, the total common equity requirement is 6 percent and the total capital requirement is 10.5 percent (compared to 8 percent in Basel II). The CCB requirement is intended to

oblige banks to build up the buffer in favourable economic conditions so as to be able to absorb shocks in periods of stress and, at the same time, gives the regulatory authorities the ability to impose restrictions on paying dividends and bonuses when the buffer falls below the required level. Finally, on the basis of macroprudential considerations of counter-cyclicality, Basel III proposes a further counter-cyclical buffer, which supervisory authorities can require to be built up during periods of economic expansion so that excess credit growth is restrained, while on the other hand the buffer is intended to enable banks to have sufficient capital to continue extending credit during periods of economic contraction.

2.2 New Leverage Ratio, Liquidity Cover Ratio, and Net Stable Funding Ratio

The new leverage ratio (defined as a minimum ratio of Tier 1 capital to total exposures) is intended to restrain excessive leverage by putting a cap on the build-up of leverage, as well as to introduce a safeguard against model risk and measurement errors. In addition, by virtue of the liquidity cover ratio (LCR), the institution is expected to maintain a sufficient level of high quality and unencumbered liquid assets (HQLA) to cover total cash outflows over a 30-day period in stressed conditions. In doing so, the institution is expected to draw up specific operational procedure in ensuring such level or assets meet the expected regulatory requirements. Finally, the net stable funding ratio is intended to require banks to have sufficient stable sources of funding to allow for a sustainable maturity structure of assets and liabilities over a one-year time horizon under extended stressed credit conditions.

2.3 SIFIs

The introduction of the concept of SIFIs has required regulatory authorities to develop policies to reduce the riskiness of systemically important institutions from an international (cross-border) perspective, with the option for supervisors to pay attention to institutions that are significant at the regional or national level. The introduction of this requirement is intended to reduce the risk of failure of certain institutions by requiring the regulatory authority to step in with increased supervision. In this respect, the need to manage risk before it reaches systemic proportions is highly desirable because the requirement not only requires the supervisors to step in by putting in place necessary management and extra processes, but also provides the basis for requiring shareholders to provide extra capital buffers to absorb losses.

2.4 Stress Testing

Basel III sets out 15 principles for stress testing to be followed by financial institutions and a further 6 to be followed by supervisors. The principles cover the overall objectives, governance, design, and implementation of stress testing programmes as well as issues related to stress testing of individual risks and products The aim is to induce financial institutions to implement a robust stress testing programme, and to review and validate the methodologies and hypotheses as well as the chosen scenarios.

3. OPERATIONAL RISK: THE BASEL METHODOLOGY

As for the methodology for operational risk, the requirement remains unchanged. To reiterate, the Basel II framework presents three methods for calculating operational risk charges "in a continuum of increasing sophistication and risk sensitivity." These are: (1) the Basic Indicator Approach; (2) the Standardised Approach; and (3) the Advanced Measurement Approaches. Internationally active banks and those with significant risk exposures are expected by the BCBS to use a more sophisticated approach than the Basic Indicator Approach, one appropriate for the "risk profile of the institution."

3.1 The Basic Indicator Approach (BIA)

This approach uses *a gross income* as a *proxy measure* of exposure to operational risk. Hence, it requires banks to hold capital for operational risk equal to the average over the previous three years of a fixed percentage of positive gross income. Years in which gross income is negative are ignored. The proposed percentage is 15 percent. Gross income is defined (for conventional banks) as "net interest income plus net non-interest income." This measure should: (1) be gross of (a) any provisions and (b) operating expenses, including fees paid to outsourcing service providers (however, fees received for providing outsourcing services should be included); and (2) exclude (a) realised profits/losses from the sale of securities in the banking book, and (b) extraordinary or irregular items, as well as income derived from insurance.

It will be clear from the above that if any such approach—either the basic indicator or the standardised approach (which uses similar but more refined proxy measures of operational risk exposure)—is to be applied to Islamic banks, gross income needs to be defined so as to reflect the nature of their operations, as discussed in Section 3.2 below.

3.2 The Standardised Approach (SA)

This is a refinement of the BIA in which banks' activities (and gross income) are divided into eight lines of business (LOBs), and the total capital charge is calculated as the three-year average of the simple addition of the capital charges across the eight business lines in each year. A negative capital charge in any one year for one LOB is offset against the positive capital charges for the other LOBs in that year, unless the total for the year is negative, in which case the input for the year to the three-year calculation is zero. The percentage for the different LOBs lines varies from 18 percent for corporate finance, trading and sales, and payment and settlement, through 15 percent for commercial banking and agency services, to 12 percent for retail banking, asset management, and retail brokerage.

Basel II also allows a variant of the SA, the alternative standardised approach (ASA), to be used subject to national supervisory discretion. Under the ASA, the capital charges for two LOBs, commercial and retail banking, are calculated using "loans and advances" instead of gross income as the indicators of exposure to which the percentages (15 and 12 percent, respectively) are applied. Commercial and retail banking may be aggregated into one LOB, in which case the percentage to be applied is 15 percent.

3.3 Advanced Measurement Approaches (AMA)

These approaches, use of which is subject to supervisory approval, allow banks to develop their own proxy measures of operational risk exposure.

4. OPERATIONAL RISK IN ISLAMIC BANKS

In the context of the Islamic financial services industry, appropriate systems, processes, and products are all recent developments. The Islamic Financial Services Board (IFSB) had adopted the same definition with some changes to cater for the specific nature of Islamic banking operations. Operational risk as per the IFSB is defined as "the risk of loss resulting from inadequate or failed internal processes, people, and systems or from external events, which includes but is not limited to, legal risk and *Shari'ah*–non-compliance risk. This definition excludes strategic and reputational risk." Continued growth in the industry poses a continual challenge in these areas of development, and failures in managing these areas will bring negative consequences.

4.1 Operational Risk Exposures in Islamic Banks

The crisis and recent regulatory development imposed on conventional institutions will have an implication on the management of the operational risk in Islamic banks. Among other things, in the medium term, as banks increase their capital ratios, the limited *Shari'ah*-compliant instruments may have an impact on the way Islamic banks meet the prudential requirements. The proposed new regulation is also likely to result in significantly higher IT costs due to changes in some processes that need to be improved, as well as in the management of liquidity and stress testing infrastructural requirements.

Operational risks faced by Islamic banks can be divided into three categories (certain risks that could be classified as legal risks are included, as mentioned in (c) (ii) below:

a. Operational risks that are consequential upon various kinds of banking activities, and which are somewhat similar for all financial intermediaries, whether *Shari'ah*-compliant or not. However, the asset-based nature of financing products in Islamic banking such as *murabahah*, *salam*, *istisna'a*, and *ijarah* may give rise to forms of operational risk in contract execution that are specific to such products.

b. *Shari'ah*–non-compliance risk—that is: (i) risks relating to potential non-compliance with *Shari'ah* rules and principles in the bank's operations; and (ii) the further risk associated with the Islamic bank's fiduciary responsibilities as *mudarib* towards fund providers under the *mudarabah* form of contract, according to which in case of misconduct or negligence by the *mudarib* the funds invested by the fund providers become a liability of the *mudarib*. *Shari'ah*–non-compliance risk is the risk of non-compliance resulting from a failure of an Islamic bank's internal systems and personnel that should ensure its compliance with the *Shari'ah* rules and principles determined by its *Shari'ah* board or the relevant body in the jurisdiction in which the Islamic bank operates.

c. Legal risks may arise either from: (i) the Islamic bank's operations (i.e., legal risks common to all financial intermediaries); or (ii) problems of legal uncertainty in interpreting and enforcing *Shari'ah* contracts. This latter category is appropriately included among operational risks.

Though the nature of operational risk related to the banking operations of Islamic banks can be similar to that of conventional banks, the severity of such risk may be greater in an Islamic bank in certain cases, as, for example: (i) *Shari'ah*-compliant products may involve more processing steps than their conventional counterparts; (ii) Islamic banks typically hold more physical assets on their balance sheets than conventional banks; and (iii) an Islamic

bank may encounter higher risk related to information technology products and systems due to scarcity of standardised products for Islamic banks.

With regard to (a) above, it should be noted that Islamic products tend to be more complex than their conventional counterparts, requiring more processing steps and hence leaving more room for error. Islamic banks typically hold more physical assets on their balance sheets than conventional banks and are exposed to operational risks associated with these. In addition, the operational risks associated with information technology (IT) in Islamic banks may exceed those in conventional banks for which more standardised software is likely to be available.

With regard to (b)(i) above, *Shari'ah* compliance is critical to an Islamic bank's operations, and such compliance requirements must permeate throughout the organisation and its products and activities. As a majority of the fund providers use *Shari'ah*-compliant banking services as a matter of principle, their perception regarding the Islamic bank's compliance with *Shari'ah* rules and principles is of great importance in maintaining their customer loyalty. In this regard, *Shari'ah* compliance is considered as falling within a higher-priority category in relation to other identified risks. However, it should be noted that *reputational risk*, including that relating to *Shari'ah* compliance, falls outside the Basel II definition of operational risk.

In most jurisdictions, *Shari'ah* compliance is achieved principally through the mechanism of a separate *Shari'ah* supervisory board, which has the responsibility of laying down the *Shari'ah* principles and rules to which the institution should adhere. The *Shari'ah* supervisory boards, typically, also advise on any issues surrounding new products or new structures and have a responsibility to report, at year-end, on satisfactory *Shari'ah* compliance by their associated institutions in the process, documentation, structure, as well as whenever the Islamic bank accepts deposits and investment funds. Such boards satisfy themselves as to proper adherence to the principles and rules laid down through a process of internal and external *Shari'ah* reviews. The management of *Shari'ah* compliance risk therefore requires that there should be timely information concerning products, services, and findings from the management to the *Shari'ah* supervisory board. Since the industry is growing at a rapid pace, the requirement for expertise in *Shari'ah* aspects in various departments is a significant factor. Inadequately trained staff will expose the Islamic bank unnecessarily to such operational risks, including the risk of income not being recognised as permissible when there is a failure in *Shari'ah* compliance.

As for (b)(ii) above, fiduciary risk is the risk that arises from an Islamic bank's potential failure to perform in accordance with explicit and implicit standards applicable to its fiduciary responsibilities, especially in its role as *mudarib*. As a result of losses on investments, an Islamic bank may become

insolvent and therefore unable either (a) to meet the demands of current account holders for repayment of their funds, or (b) to safeguard the interests of its investment account holders (IAHs). An Islamic bank may fail to perform due diligence or to act with sufficient prudence when making and managing investments, resulting in risks of forgone profits or of losses to its IAHs.

4.2 Capital Requirements for Operational Risk in Islamic Banks

The IFSB has set out capital requirements for Islamic banks in its Capital Adequacy Standard IFSB-2 (December 2005).[1] These are based on the basic indicator approach, with *gross income* being redefined in an appropriate manner as indicated below, and 15 percent being used as the standard percentage. As the LOBs into which Islamic banks are organised are different from those set out in Basel II, the IFSB proposes that, at the present stage, the basic indicator approach be used by Islamic banks. However, subject to the supervisory authority defining the applicable LOBs, it may allow Islamic banks in its jurisdiction to apply the Standardised Approach (SA) in which the percentage (12, 15, or 18 percent) of gross income is to be set aside according to the LOB.

Gross income is defined as the sum of:

a. Net income from financing activities (e.g., selling price less purchase price in *murabahah* and *salam*, lease rentals in *ijarah*), or gross of any provisions and operating expenses and of depreciation of *ijarah* assets.
b. Net income from investment activities.
c. Fee income (e.g., commissions and agency fees).

Less:

d. IAHs' share of income.

Net income from financing activities under (a) includes both the share of IAHs and the Islamic bank's share as *mudarib* or as managing partner in a *musharakah* with IAHs. The IAHs' share of such income is deducted under (d).

Gross income excludes extraordinary income and income from insurance activities.

4.3 Risk Management Guidelines

In addition, guidelines for the management of operational risk are proposed by the IFSB. These guidelines operate through process regulation, which

requires the Islamic bank to have in place appropriate processes and procedures to identify, measure, monitor, and control operational risk.

5. UNIQUE OPERATIONAL RISKS OF ISLAMIC FINANCING/ INVESTMENT MODES

In this section, without seeking to be exhaustive, we review some aspects that may give rise to operational risks consequential upon specific financing or investment modes.

5.1 *Murabahah*

Murabahah is one of the most predominantly used contracts in Islamic finance. Apart from credit risk exposures, there are two types of operational risk relating to the structure of a *murabahah* contract:

a. The different viewpoints of *murabahah* permissibility can be a source of operational risk. For example, IT systems employed across jurisdictions may have to be designed to meet the requirements of certain jurisdictions.
b. At the contract signing stage, since the contract requires the Islamic bank to purchase the asset first before selling it to the customer, the bank needs to ensure that the legal implications of the contract properly match the commercial intent of the transactions.

In addition, problems may arise if the *murabahah* customer acts as the Islamic bank's agent in the purchase of the asset that is the subject matter of the contract. For the *murabahah* to be valid, title to the asset must first pass to the Islamic bank and not directly to the customer. The documentation, including letters of credit, must be drawn up so as to ensure this.

Islamic banks can be involved in commodity *murabahah* transaction (CMT)–based financing in the following forms:

a. CMT for interbank operations for managing short-term liquidity surplus (i.e., selling and buying of *Shari'ah*-compliant commodities through *murabahah* transactions, which is commonly termed "placement" in conventional institutions) or where the counterparty is the central bank or monetary authority offering a *Shari'ah*-compliant lender of last resort and/or a standing facility for effective liquidity management.

b. CMT for providing financing to a counterparty by a longer-term commodity murabahah where the counterparty immediately sells the commodities on the spot market.

Some aspects of commodities' liquidity and delivery, their settlement and exit strategies, legal risk, and *Shari'ah*–non-compliance risk may entail operational risks consequential to the CMT structure.

5.2 *Salam* and Parallel *Salam*

Salam is a type of forward contract where an Islamic bank assumes the role of the forward purchaser of a commodity. In assuming the role of the purchaser, the bank exposes itself to the following operational risks:

a. The bank has to accept the goods that are the subject matter of the contract even though they are delivered early, should the specifications be met. The bank may have to incur additional costs such as warehousing, insurance, or even damage (if the goods are perishable in nature) in the event that it cannot sell the goods promptly following delivery.
b. *Salam* is generally associated with the agricultural sector. The buyer must either reject goods of an inferior quality to that specified in the contract, or accept them at the original price. In the latter case, the goods would have to be sold at a discount (unless the customer under a parallel *salam* agreed to accept the goods at the originally agreed price).
c. For *salam* with parallel *salam*, the Islamic bank may face legal risk if the goods cannot be delivered at the specified time (unless the customer under parallel *salam* agrees to modify the delivery date).

5.3 *Istisna'a* and Parallel *Istisna'a*

Istisna'a is another type of forward contract, but the role of an Islamic bank as a financial intermediary differs from that in a *salam* contract. An *istisna'a* contract is an agreement between a seller (*al-sani'*) and the (ultimate) buyer (*al-mustasni'*) to manufacture or construct a nonexistent asset which is to be manufactured or constructed according to the ultimate buyer's specifications and is to be delivered on a specified future date at a predetermined selling price.

In an *istisna'a* contract, price and other necessary specifications must also be fixed and fully settled between the buyer and manufacturer/builder. The payments by the buyer in *istisna'a* may be made in advance during the period

of construction reflecting stages of completion, or deferred to a specified future date. The contract of *istisna'a* is a binding contract that cannot be cancelled unilaterally by either party once the manufacturing or construction starts. If the subject matter does not conform to the specification agreed upon, the buyer has the option to accept or to refuse the subject matter. The subject matter on which transaction of *istisna'a* is based is always an item that needs to be manufactured or constructed, such as a ship, an aircraft, or a building, and it cannot be an existing and designated asset. *Istisna'a* may also be used for similar projects like installation of an air-conditioning plant in the customer's factory, or building a bridge or a highway.

In respect to the above, the common practice is that the bank contracts to supply a constructed asset (such as a building or a ship) for a customer. In turn, the bank enters into another *istisna'a* with a contractor in order to have the asset constructed.[2] Its reliance on the counterparty in the other *istisna'a* (the subcontractor) exposes it to various operational risks, which need to be managed by a combination of legal precautions, due diligence in choosing subcontractors, and technical management by appropriately qualified staff or consultants of the execution of the contract by the subcontractor. Islamic banks that specialise in *istisna'a* financing may have an engineering department. Risks may include the following:

a. The Islamic bank may be unable to deliver the asset on time, owing to time overruns by the contractor under the parallel *istisna'a*, and may thus face penalties for late completion.
b. Cost overruns under the parallel *istisna'a* contract may, unless agreed with the customer under the *istisna'a* contract, have to be absorbed partly or wholly by the Islamic bank.
c. The subcontractor may fail to meet quality standards or other requirements of the specification, as agreed with the customer under the *istisna'a* contract. The Islamic bank may face legal risk if no agreement is reached with the subcontractor and the customer either for remedying the defects or for reducing the contract price.
d. If the contractor turns out to be unable to complete the work, the bank will need to find a replacement. In certain cases, this may be very difficult and costly.

5.4 *Ijarah* and *Ijarah Muntahia Bittamleek*

In simple terms, an *ijarah* contract is an operating lease, whereas *ijarah muntahia bittamleek* (IMB) is a lease-to-purchase (a *Shari'ah*-compliant alternative to a finance lease). While operational risk exposures during the

purchase and holding of the assets may be similar to those in the case of *murabahah*, other operational risk aspects include the following:

a. The Islamic bank needs to ensure that the asset will be used in a *Shari'ah*-compliant manner. Otherwise, it is exposed to nonrecognition of the lease income as nonpermissible and the need to repossess the asset and find a new lessee.
b. If the lessee damages the assets in its possession, the Islamic bank may face refusal by the lessee to make the damage good. In such a case, the bank needs to be able to repossess the asset and to take legal action against the lessee to recover damages.
c. If the leased asset is severely damaged or destroyed through no fault of the lessee, the Islamic bank as lessor is required to provide an alternative asset, failing which the lessee can terminate the lease without paying rentals for the remaining duration of the contract. Unless the asset is insured, this will result in a loss to the Islamic bank.
d. The Islamic bank may be exposed to legal risk in respect of the enforcement of its contractual right to repossess the asset in case of default or misconduct by the lessee. This may be the case particularly when the asset is a house or apartment that is the lessee's home, and the lessee enjoys protection as a tenant.

5.5 *Musharakah*

Musharakah is a profit- and loss-sharing partnership contract. The Islamic bank may enter into a *musharakah* with a customer for the purpose of providing a *Shari'ah*-compliant financing facility to the customer on a profit- and loss-sharing basis. The customer will normally be the managing partner in the venture, but the bank may participate in the management and thus be able to monitor the use of the funds more closely. Typically, a diminishing *musharakah* will be used for this purpose, and the customer will progressively purchase the bank's share of the venture. Operational risks that may be associated with *musharakah* investments are as follows:

a. The Islamic bank may not perform adequate due diligence in appraising the venture to be financed and the soundness and reliability of the customer. Lack of appropriate technical expertise can be a cause of failure in a new business activity.
b. During the *musharakah* investment period, the bank may not carry out adequate monitoring of the financial performance of the venture, and may fail to receive adequate financial information in order to be able to do so.

5.6 *Mudarabah*

Mudarabah is a profit-sharing and loss-bearing contract, under which the financier (*rab al mal*) entrusts his funds to an entrepreneur (*mudarib*). Since this type of contract may be used on the assets side of the balance sheet, as well as being used on the funding side for mobilizing investment accounts, the operational risk is first analyzed from the assets-side perspective and then from the funding-side perspective (which is related to fiduciary risk).

a. **Asset-side *mudarabah*.** Contractually, an Islamic bank has no control over the management of the business financed through this mode, the entrepreneur having complete freedom to run the enterprise according to his best judgement. The bank is contractually entitled only to share with the entrepreneur the profits (or losses) generated by the venture according to the contractually agreed profit-sharing ratio. The entrepreneur as *mudarib* does not share in any losses. The *mudarib* has an obligation to act in a fiduciary capacity as the manager of the bank's funds, but the situation gives rise to moral hazard, especially if there is information asymmetry—that is, the bank does not receive regular and reliable financial reports on the performance of the *mudarib*. Hence, in addition to due diligence before advancing the funds, the bank needs to take precautions against problems of information asymmetry during the period of investment.
b. **Funding-side *mudarabah*.** Profit-sharing (and loss-bearing) investment accounts are a *Shari'ah*-compliant alternative to conventional interest-bearing deposit accounts. Since a *mudarabah* contract is employed between the Islamic bank and its investment account holders, the IAHs share the profits and bear all losses without having any control or rights of governance over the Islamic bank.

In return, the Islamic bank has fiduciary responsibilities in managing the IAHs' funds. The IAHs typically expect returns on their funds that are comparable to the returns paid by competitors (both other Islamic banks and conventional institutions), but they also expect the Islamic bank to comply with *Shari'ah* rules and principles at all times. If the Islamic bank is seen to be deficient in its *Shari'ah* compliance, it is exposed to the risk of IAHs withdrawing their funds and, in serious cases, of being accused of misconduct and negligence. In the latter case, the funds of the IAHs may be considered to be a liability of the Islamic bank, thus jeopardising its solvency.

5.7 *Sukuk* Securitisation

Sukuk securitisation is the financial engineering process for the creation and issuance of *sukuk*, where payment of principal and profits are derived from the cash flows generated from the underlying assets in the securitisation. Asset-backed *sukuk* securitisations (see below) include the process whereby ownership of the underlying assets is transferred to a large number of *sukuk* investors via a special purpose entity (SPE). The IFSB's Exposure Draft[3] categories two types of *sukuk* structures:

a. Asset-backed *sukuk* use securitisation structures that insulate the *sukuk* holders from exposure to any financial problems of the originator but leave them exposed to losses in case of the impairment of the securitised assets. The applicable risks are thus those of the underlying assets, and these will in principle be reflected in any credit rating issued by a recognised ECAI. For a *sukuk* to be considered asset backed, it is necessary that the key securitisation elements are in place to ensure that *sukuk* holders have legal title and realisable security over the assets.

b. In asset-based *sukuk*, the originator typically transfers only the beneficial ownership of, or merely rights to cash flows from, the assets to the SPE; therefore, there is no true sale. Since investors have no recourse to the assets, the transaction does not focus on asset risk, but rather on the credit worthiness of the originator of the *sukuk*. The originator typically provides a repurchase undertaking (i.e., a commitment to buy back the underlying assets at maturity) to the *sukuk* holders. The applicable credit risk is that of the originator, subject to any *Shari'ah*-compliant credit enhancement by the issuer. The recognised ECAI will put weight, in determining the rating, on the payment schedule of the repurchase undertaking and the capability of the originator to make the scheduled payments to the issuer SPE. The periodic distribution amounts (also called coupons) are protected by a liquidity provision (i.e., the commitment of the originator/guarantor to provide sufficient liquidity to make up for any time-lag between receipt of asset returns and due dates of periodic distributions). Such asset-based *sukuk* are sometimes referred to as "pay-through" structures, since the income from the assets is paid to the investors through the issuer SPE. Another category of asset-based *sukuk* is based on a so-called pass-through structure, whereby a separate issuing entity purchases the underlying assets from the originator, packages them into a pool and acts as the issuer of the *sukuk*. This issuing entity requires the originator to give the holders recourse, but provides *Shari'ah*-compliant credit enhancement by guaranteeing repayment in case of default by the originator.

5.8 Real Estate Investment

Conventional financial institutions in general cannot engage in real estate investments unless they obtain consent from the regulatory authority. These institutions are required to comply with applicable capital standards, and the authority determines that the activity poses no significant risk to the depositors. They also need to have an adequate risk management process in place, and the overall financial conditions (including capital requirements) should be able to withstand potential risk associated with the holding of investment or financing property. In most instances, the authorities require conventional institutions to establish a subsidiary or dedicated branch to conduct the real estate activities, so as to place these activities in a separate corporate entity and thus not expose their depositors to the risks of such investments.

The construction boom in the some Gulf Cooperation Council countries reveals that that it is common to find Islamic banks that have half of their assets linked to real estate, to the extent that these Islamic banks are exposed to the real estate sector, through *musharakah* and *istisna'a* contracts.[4]

Unlike conventional banks, real estate exposure for Islamic banks does not come in the form of a loan. Instead, the exposure typically takes the form of a profit-sharing contract—Islamic banks put their capital at risk in the form, effectively, of an equity stake. It may not have the same kind of direct management involvement that a private equity firm would and, as such, an Islamic bank's exposure depends on both the skill and honesty of its partner. Islamic banks may also act as property co-developers and/or then co-owners, an activity normally undertaken by real estate specialists.

Such types of real estate activities raise supervisory issues, particularly with respect to risk management, capital adequacy, and transparency, especially during economic downturns. These are certainly the areas that need greater scrutiny—in fact, because the real estate assets the Islamic banks are financing continue to be owned by their clients, much Islamic bank exposure to real estate risk may not appear on the sector's balance sheets. In addition, real estate risk concentrations are also common among Islamic banks—their geographic reach tends to be limited, as are the types of assets they are able to accept. Hedging, including risk transfer through securitisation, is mostly limited.

Briefly, sources of operational risk related to real estate can be viewed from two angles, namely, the strategic level and the impairment of real estate. While strategic risk is not considered as part of the operational risk under the definition of the operational risk, an Islamic bank needs to be critical regarding the creation of value. The potential for structural failure of a key facility could create operational risk.

The other potential operational risk is on the impairment of such real estate. The potential for the decline (or increase) in the value of real estate assets is driven by both the property market and its regional and national economy. Properties whose market value is below book value are common in the corporate world. Recognition through write-downs may impede the execution of strategy by adversely affecting credit ratings and analysts' outlook for public companies. Similarly, especially when operating in less mature markets, property values can be impacted not only by rapid currency shifts but also by a change in policy by a national government. Hence, exposures to property market and economic/political risks are often unpredictable.

Another source of asset impairment risk is related to the intangible value created by the corporate real estate. Properties often carry an organisation's brand, especially in the retail and leisure sectors. A lack of investment in these facilities can undermine the brand and reduce the value of the organisation. Additionally, the workplace is often a key symbol in creating corporate culture and any misalignment between the corporate mission and the working environment can also impede the implementation of strategy. In the retail sector, successive format shifts or innovations cause obsolescence in existing stores without any change in the physical condition or the surrounding market.

The other source of asset impairment relates to physical damage to an asset. Property assets are exposed to fire, floods, terrorist attacks, and other catastrophes. The real estate manager must assess these risks in each situation, determining the extent to which on the one hand they are likely to occur and on the other hand whether the facility houses operations that affect the business value. Islamic banks may insure themselves against many of these risks, but they also need to develop contingency plans for rehousing the critical operations.

In certain jurisdictions, the supervisory authorities provide more detailed and specific guidance on the definition and classification of permitted real estate activities. In recent years, many supervisory authorities have been quite proactive in supervising the real estate portfolios of Islamic banks in their jurisdictions and, thus, have updated their regulations and guidelines to align with the rapidly changing market realities.

6. *QARD*

Qard is a loan given by an Islamic bank (or other lender), such that the borrower is contractually obliged to repay only the principal amount borrowed. In the contract of *qard*, no additional payment other than the principal amount lent can be required, as that would be a form of *riba*. If a fixed period of repayment is stipulated in the contract, the borrower is liable

to pay back the principal amount to the lender on or before the agreed date of payment. On the other hand, if no period is stipulated in the contract, it is binding upon the borrower to make a repayment of the loaned amount to the lender on demand. Islamic banks provide financing to their customers as financial intermediaries and seek opportunities to earn profits for their shareholders and fund providers. Therefore, most Islamic banks will not provide any significant amount of lending on the basis of *qard*, as *Shari'ah* rules and principles require the borrower to pay only the principal amount in that case. The main category of risk related to *qard* can be considered as credit risk. However, from the operational risk perspective, an Islamic bank is exposed to the strategic decision on how much the management is willing to allocate to such contracts (as part of meeting their social obligations) given that no financial benefits can be generated from such financing.

6.1 *Wakalah*

In an asset-side *wakalah* contract, an Islamic bank assumes the role of a principal (*muwakkil*) and appoints the customer as agent (*wakeel*) to carry out a specified set of services or act on its behalf. This section is applicable to both restricted and unrestricted *wakalah* financing. *Wakalah* is a contract of agency whereby one person contracts to perform any work or provide any service on behalf of another person. Businesses rely on a range of individuals to act on their behalf, and these include employees, directors, and partners as well as a range of professional agents. An action performed by an agent on behalf of the principal will be deemed to be an action by the principal. An agent will obtain a payment wage for services rendered according to the contractual reward structure offered by the principal, which may incorporate a performance-related element.

The Islamic bank as principal (*muwakkil)* is exposed to the risk of losing its invested capital (i.e., capital impairment risk). Any loss on the investment is to be borne solely by the *muwakkil*, but is limited to the amount of its capital. Losses that are due to fraud, misconduct, negligence, or breach of contractual terms are to be borne by the *wakeel*. Therefore, the Islamic bank is exposed to the skills of the *wakeel* that manages the investments on behalf of the bank as well as business risks associated with the underlying activities and types of investments or assets of the *wakalah* agreement.

6.2 Impacts of Current Regulatory Development on Operational and Other Aspects of Risk Management

As can be seen from the above explanations, Islamic banks are still exposed to credit, market, operational, and reputational risks similar to those of

conventional banks. Islamic banks face unique challenges, however, in managing liquidity. Given the restricted range of instruments to manage the liquidity requirements, an Islamic bank needs to manage its innovative risk management and compliance so that all relevant staff involved in the process will be fully aware of the risks that may emerge from such a situation. An Islamic bank is also expected to run stringent stress testing and scenario analysis to avert potential liquidity problems.

In this respect, the IFSB has issued a number of standards as well as others in the pipeline designed to complement the work of other international standards. The works include:

a. Liquidity Risk Management: the *Guiding Principles of Liquidity Risk Management* sets out to provide a set of principles for the robust management of liquidity risk by an Islamic bank and its vigorous supervision and monitoring by the supervisory authorities, taking into consideration the specificities of the Islamic bank and complementing relevant existing and emerging international best practices. This document sets out 22 guiding principles in the area of liquidity risk management for Islamic banks, In addition to highlighting necessary conditions for effective liquidity risk management in the Islamic bank, this document provides principles for liquidity risk management by Islamic banks, as well as principles for related monitoring and supervision by the supervisory authorities.

b. Stress Testing: The Guiding Principles are divided into two parts: (i) 22 Guiding Principles on stress testing for Islamic banks; and (ii) 6 Guiding Principles on stress testing for supervisory authorities. The framework should guide Islamic banks in assessing and capturing vulnerabilities under various stress-testing scenarios, including extreme but plausible shocks, in order to achieve the following, *inter alia*:
   - Identify how different portfolios respond to changes in key economic variables (e.g., benchmark rates, foreign exchange rates, credit quality, etc.).
   - Monitor the quality of assets to identify existing and potential loss exposures.
   - Evaluate potential threats to the Islamic bank's ability to meet its financial obligations at any time arising from either funding or market liquidity exposures.
   - Estimate the impact of stress events on baseline profit (as profits normally act as the first line of defence before dipping into capital).
   - Analyse the Islamic bank's ability to meet its capital requirements at all times throughout a reasonably severe economic recession.

For supervisory authorities, stress testing can be used (i) as a surveillance tool for periodically testing the safety and soundness of the financial system, and (ii) from a financial stability perspective, to identify "weaknesses" in the financial system and structural (systemic) vulnerabilities arising from the specific risk profiles of Islamic banks individually and collectively.

a. Revised Capital Adequacy Standard (an exposure draft at the time of writing): The new standard aims to provide a comprehensive guidance to supervisory authorities, and to the institutions themselves, on the application of Basel III capital adequacy regulations to Islamic banks, by combining and updating the contents of IFSB-2 and IFSB-7, thus providing a level playing field for Islamic banks vis-à-vis conventional market players.
b. Revised Supervisory Review Process: The revision aims to provide guidance to the supervisory authorities on key elements in the supervisory review process (SRP) of an Islamic bank, taking into consideration the specificities of the Islamic bank, and the lessons learned from the financial crisis; at the same time, to complement the existing international guidance on SRP. It is envisaged that this revision will strengthen the management of risks in the Islamic financial services industry.

7. CONCLUDING REMARKS

In summary, the current regulatory requirements are likely to have impacts on the IT systems of Islamic banks as well as on their operations. With regard to IT-related matters, institutions are expected to manage the monitoring of their liquidity risk very closely. The computation of the above-mentioned ratios has to be addressed in advance of the actual implementation that will take place over the next few years. Emerging from such requirements is the need for more comprehensive reporting to both regulatory authorities and the public. As a result, the new processes and procedures, as well as reporting and disclosures, will be expected to improve over time. The indirect impacts on the staff training and skills will also increase the challenge to Islamic banks, because regulatory changes to implement Basel III will be of a more dynamic nature as it comes in stages.

It will be apparent from the above that Islamic banks are exposed to a number of operational risks that are somewhat different from those faced by conventional banks. The relative complexity of a number of their products, as well as their relative novelty in the contemporary financial services market, including *sukuk* securitisations and real estate investment, combined with the

fiduciary obligations of an Islamic bank when its acts as a *mudarib*, imply that for Islamic banks operational risk is a very important consideration.

For these reasons, the IFSB has taken the position that, while IAHs may be considered (in the absence of misconduct and negligence by the Islamic bank) to bear the *credit and market risks* of assets in which their funds have been invested by the bank, the latter must be considered as being exposed to the *operational risk* arising from its management of those funds. The new developments taking place in IFSB standards and guidelines require Islamic banks to revisit their operational requirements, as they must ensure that they have the processes in place to remain compliant and at the same time profitable.

NOTES

1. This standard is currently in the course of revision, but the revisions do not affect the treatment of operational risk, except that an Alternative Standardised Approach (ASA) is included. Under ASA, the operational risk capital charge is calculated in the same way as under TSA, except for two business lines (i.e., retail banking and commercial banking). For these two business lines, instead of using relevant gross profit, the amount of financing in each LOB is multiplied with a fixed factor of 0.035 to obtain the indicator of exposure.
2. When two *istisna'a* contracts are entered into back-to-back, one of them is referred to as a parallel *istisna'a* contract. Commonly, the contract that is entered into second (chronologically) is considered to be the parallel *istisna'a* contract.
3. IFSB Exposure Draft on Revised Capital Adequacy Standard for Institutions Offering Islamic Financial Services [Excluding Islamic Insurance (*Takāful*) Institutions and Islamic Collective Investment Schemes] Nov 2012.
4. PricewaterhouseCoopers, "Growing Pains: Managing Islamic Banking Risks," 2008, www.pwc.com/en_GX/gx/financial-services/pdf/growing_pains.pdf.

CHAPTER 8

Information Technology Risks in Islamic Banks

Samir Safa

1. INTRODUCTION

The Islamic finance (IF) industry is rigorously struggling to maintain the progress that was visibly started in the last couple of decades despite the growth that it has witnessed. The industry is yet to reach a level of sustainability, despite various initiatives in standardisations (accounting, compliance regulation, processes, legal documentation, and information systems), evolving knowledge of the industry (it is still lacking *real* innovation), enhancing *Shari'ah* awareness (taking into consideration the differences in interpretation), reaching out to the various markets (which are still very humble), and creating awareness (that is slow and in many cases not effective).

For the IF industry, information technology and systems (ITSs) pose a prominent challenge due to the industry's lack of maturity, which could have direct implications and risks for the IF industry. One of the main reasons for the modest growth and expansion of the IF industry is the ineffectiveness of the currently available ITSs in addressing the real challenges of the IF operating model. This really had a direct impact in providing the appropriate technological platform for Islamic financial institutions (IFIs) to conduct their business, address their operational needs, and mitigate various risks effectively.

This challenge can be seen more clearly within the Islamic banks (or major groups of such banks) that operate as "universal" banks, combining investment as well as retail banking, and attempt to provide IF services and products as part of their global offering in their respective markets. The same

Islamic Finance: The New Regulatory Challenge.
Edited by Simon Archer and Rifaat Ahmed Abdel Karim
Copyright © 2013 by John Wiley & Sons Singapore Pte. Ltd.
ISBN: 978-1-118-62897-3

applies even more to the major conventional banking groups that offer Islamic banking through Islamic "windows."[1] The implementation, management, and administration of the IT infrastructure and systems of these banks to both banking models have a potential for high operational risks (i.e., overseeing and handling the coexistence of the conventional banking operations along with the IF window remains a dilemma that imposes an increase magnitude of risks to these banks).

Moreover, the lack of a system that genuinely complies with *Shari'ah* standards and principles (i.e., a system built with the primary purpose of supporting the IF operating model), seems to have forced the majority of IFIs to adopt conventional banking operational systems already available in the market. This has contributed to a great extent to amplifying the elements of risk that will be the focus in the following sections.

It appears that these elements of risk in ITSs have yet to be seriously analysed and assessed. This is the case despite the sizeable risks imposed on the IF industry and the direct implication that will affect the relevant IFIs, especially in the area of *operational risk*.

The deficiencies of ITSs in the IF industry reside in various areas that could possibly violate both the basic IF principles and standards of the IF operating model. The latter in turn could lead to immediate concerns with the regulatory bodies, and apparently put the *Shari'ah* compliance of these IFIs under significant pressure.

The following section attempts to explore and explain important issues in the current IF/ITS trends, practices, and challenges. These will be compared with those in the conventional banking sector because the majority of the available (and dominant) banking ITSs in the market for IFIs were originally developed to address the conventional banking operational and business framework.

It appears that the suppliers of these systems have tweaked their systems in an attempt to tailor them to the IF operational model. However; in many cases, these suppliers seem to have made some basic errors. This has posed operational risks to the IF, and has violated some fundamental principles in IF, resulting in exposure to IF *Shari'ah*–non-compliance risk. However, despite its gravity, this matter is not being addressed in depth by various bodies and the industry. There has also yet to be any major initiative towards attending to these risks, which would continue to expose the banks to operational and other related risks.

Below are a few examples that aim to draw the attention of the reader to the ITS risks in the IF industry, the areas that are likely to be more exposed to the risks within these banking systems, and how possibly these could impact the IF operational model. However, no discussion or remedies of these issues will be attempted, as the required remedies tend to vary among

the various systems. This is mainly due to the functional and technical architecture of an ITS. In addition, various scenarios and environments will require different approaches and solutions.

2. IMPORTANT UNDERSTANDINGS AND FACTS

The principles and operational specifics of the IF have fundamental differences in comparison to the understanding and practices in the conventional banking framework. The available enterprise banking systems that are used by most of the IFIs in retail, corporate, investment, and treasury and capital markets were built originally for conventional banks' requirements and needs.

2.1 Fundamental Principles

Given the fundamental differences in both banking models, the issues and concerns would tend to surface when the IFIs utilise IT systems that were developed for conventional banking. However, this does not mean that these systems cannot be used in some functional and operational areas that are applicable to the IFIs, which are similar in functionality to the conventional banks.

For example, in the area of core banking, IFIs are required (like conventional banks) to issue and process cheques and to manage the clearing process of these cheques. They also need to interface with standard mechanisms of settlement such as SWIFT (Society for Worldwide Interbank Financial Telecommunication) or other local settlement hubs or switches. The IFIs are also required to conduct "Know Your Customer" reviews by their regulatory authority (e.g., central bank). They have to service their customers via various delivery channels (e.g., ATM, Call Centre, Branch, Internet, etc.), as well as to levy and manage fees and various other charges to their customers—as long as there is no consideration that would be considered to constitute interest. In addition, there are other processes, which are common and similar to those of conventional banks. None of these processes raise *Shari'ah*–non-compliance issues nor do they have implications for other operational risks.

The contributing elements to risks in the ITSs of the IFIs are:

- The lack of understanding of the IF guidelines and principles by the vendors or systems providers—the developer.
- The inflexibility and poor functionality of some of the available conventional systems that do not assist the implementer (i.e., the end user) to address the needs of the IFIs.

- Absence of comprehensive and focused development initiatives in the IF arena, whilst the conventional systems processes, standards, and viability are still attracting large investments in R&D in banking systems.
- Even vendors who claim to have built systems that specifically address the requirements of the IF operational model have yet to resolve the underlying challenges, needs, and pressures that the IF industry in general and the IFIs in specific are experiencing.

2.2 ITS Issues and Concerns

Exploring the previous statements in more depth, there are specific remarks and concerns that should be highlighted:

- IF is not only about banning interest, and it is not just about replacing the word *interest* with *profit*. Some suppliers of banking systems simply turn off the so-called interest flag or indicator in these systems by making a change in terminology (to put that in simple terms rather than using technical wording). This is definitely not what the substance of the IF model is all about.
- IF does not require merely changing the terminology embedded in processes and functions within the banking system. For example, renaming conventional processes in the lending component of some of these banking systems, maintaining the functionality in its existing form but then relabelling the process with terminology borrowed from an IF contract (or description), such as *murabahah* or *ijarah*, does not achieve what is needed.
- In the core banking applications, the basic key differences between IF and conventional banking include but are not limited to: (i) how the *financing* process or functionality, which replaces the lending activity in conventional banking, is addressed; and (ii) how *profit* or return on investment on assets in the "unrestricted" asset pool is calculated and allocated to each investor holding an unrestricted investment account based upon the *mudarabah* contract. These two areas are the main underlying differences that are could possibly cause risks for the IFIs.
- In the case of treasury, the challenges are also significant. It is worth mentioning here that a *treasurer* in an IFI has a major task to manage the treasury book(s) effectively owing to the limitations in manoeuvrability or the availability of *Shari'ah*-compliant instruments in this regard, in comparison to the treasurer of a conventional bank who has a variety of diversified instruments. There are significant opportunities to expose an IFI to risks and violation of *Shari'ah* compliance in case effective controls are not enforced or put into effect.

- The IF model tends to be more complex in nature in comparison with the conventional banking framework. The IF operating model has more (strict and specific) milestones and procedural controls to be in place where IFIs need to ensure compliance with *Shari'ah* through their operational procedural framework. In some instances, any violation of the logical sequence of a financing process might impact the *Shari'ah*-compliance requirement and cause a significant operational risk. Owing to that, in some cases the core banking systems' providers address this concern by having a workflow engine that manages the financing process, which is a remedy to part of the compliance issue. However, in some cases it is *not* a complete solution to the overall requirement. In the following sections this topic will be further elaborated from technical and functional aspects.

The list above generally highlights the wrong practices that some suppliers have adopted and which need attention in managing *Shari'ah*–non-compliance risk. These practices impose significant operational risks on the IFIs in terms of business, documentation, and legal issues as discussed in Section 3. The list above also paves the way to highlight in brief the technical aspects of the available enterprise banking systems, namely core banking, and treasury, and capital markets systems for IFIs (see Section 4).

3. ITS OPERATIONAL RISK—BUSINESS, DOCUMENTATION, AND LEGAL ISSUES

Information and technology systems involve several areas of operational risk as outlined in this section. Section 4 covers technical and functional clarification for these risks.

3.1 ITS Risk Considerations

The key areas of operational risk in ITS apply to various business activities as well as to documentation and legal aspects of Islamic finance. The nature of the IF operational and business framework brings more complexity due to the fact that the IF transactions have underlying assets (i.e., *murabahah*, *ijarah*, *istisna'a*, and other contracts or modes of financing), and investments, more lengthy processing cycles, and a vast array of activities from the origin of the financing until the conclusion of the transaction.

Another operational risk is how profit is calculated and allocated to investment account holders (IAH) that are mobilised based on the *mudarabah* contract. The main issue raised here is not about calculating the profit.

Rather, it is how the system manages the allocation of profit. For example, questions arise regarding how the system addresses the issue of investment accounts that mature before profits are calculated, those in which profits are allocated periodically, and others subject to early withdrawals and rollover. In *mudarabah* financing, potential operational issues might arise in repayments in general and late repayments recovery, owing to the inherited accruals process embedded in the architecture of the system(s).

The conventional banking model, to which the IT systems are geared, is based on the accrual basis. The architecture of the majority (if not all) of the available IT systems accrue interest on a daily basis at the end of each day when the processing of transactions is completed. The accrued income (interest) is posted periodically (daily mostly) into the general ledger by posting journal entries. This practice does not comply with the IF accounting standards, as profit in the IF is posted (or recognised) at maturity (or at a periodic profit distribution milestone) or on settlement. It is important to note here that the accrual technique or mechanism is in place in all asset and liability transactions and deals, such as financing and deposits.

The commodity *murabahah*, the most commonly used product for an Islamic bank's treasurer to manage a bank's short-term liquidity needs and surpluses, also raises significant operational risk issues. Given that the commodity *murabahah* is a spot purchase-and-sale product with deferred settlement terms, there is a need to address the underlying asset being purchased and sold, as well as the required documentation and confirmations involved—based upon an agency agreement in place.

Risk in documentation and legal procedures, depending on the extent of automation and the effectiveness of the financial systems that are implemented and deployed, could be mitigated if legal agreements are generated at the right time with the appropriate content, and the documents or legal confirmations produced automatically based upon the captured details of the transaction. At the very least, such an attempt would address the overall process from the perspective of timely execution.

As indicated above, if an effective system and technology platform is put in place, the IT platform could be a catalyst in mitigating risks in the IF industry, especially for the IFIs. This can be of great value depending on the model or nature of business of the IFIs and the way in which the systems are deployed to address the various areas and propositions, for instance in retail, corporate, and treasury markets. At the same time, ineffective ITS could impose serious risks on an IFI's operations.

It is worth noting that some of the risks incurred due to inadequate ITS might impact the two categories specified here, *operational* as well as *documentation* and *legal* risks, at the same time.

4. TECHNICAL AND FUNCTIONAL CLARIFICATION FOR THE IMPOSED RISKS

This section provides the reader with insights into the technical and functional aspects of these systems, in order to provide a better understanding of the examples of risks embedded in the IT systems available for the IFIs.

4.1 Investment Accounts Based upon *Mudarabah*

Investment accounts that are based on the *mudarabah* contract have major differences compared to deposits in conventional banking.

For example, a common operational risk IFIs face can be illustrated by observing the process of how most IFIs calculate the return or payment of the "profit" to the IAH in the case of early withdrawals. Such observation reveals that the process is designed to accrue profits similar to the way in which interest is accrued in a conventional system. In cases where the IFI opts to manually adjust and compensate the profit to cater to an early withdrawal by an IAH, the accruals are still posted (in most of the cases), and the IFI still needs to reverse or adjust these entries.

4.2 Profit Calculation and Allocation to IAH

Investment-account profits are not defined at the outset (i.e., when the account is opened or rolled over). Rather profits are calculated for IAH for an "identified" period, based upon the performance of the underlying assets funded by the IAH for that period.

Profit or return is usually calculated at the end of the period and then applied and back dated to the opening or rolled-over date of the account.

There are two steps to profit calculation and allocation:

The first step in this profit calculation process, regardless of the method, is mainly to identify the various rates of profit (or return rates) for every tenor and type of account with respect to those "identified" account holders who participate in the unrestricted pool of deposits. The rate (identified or calculated) is then applied to every investment account that is applicable to the relevant pool and tenor, in a back-dated fashion where the profit is calculated and passed or posted to the specific account (i.e., proportionate and time-proportional allocation of the profit applicable to that specific account with respect to the pool).

The calculation process is not the issue here. However, due to the systems' inherited architectures, this might cause operational issues that lead to

risks for not being able to *allocate* the calculated profit for an account whose maturity date falls within the profit calculation period.

The profit calculation period might not necessary match the maturity or roll-over date for the individual account within the pool of unrestricted investment accounts. Hence, when the profit is calculated, the allocation process comes into effect to pass or pay the profit to the account holder. If it turns out that an individual account has matured or is being rolled over to another future period, then some issues might surface due to the architectural framework in place. This is where it will most likely be a problem because most of the conventional banking systems, which were adapted for the majority of the IFIs, do not allow the posting (or maintaining) of any entry to a matured or a rolled-over account, so that the profit share cannot be allocated to such an account retroactively. In various cases, this area remains under consideration and brings at the same time significant risks to the operation. The key message here, however, is that in most cases, there are serious risk implications as to what remedies are used by IFIs to address this limitation and mitigate risks of incorrect profit allocation.

4.3 Financing Process Operational Issues

Some of the risks in this area were mentioned earlier. However, attention will be given to a common significant risk. In the conventional lending world, the loan is given (booked) when it is processed or upon approval. Most of the IT systems in the conventional banking segment are based on this model. In the previous illustration relating to the intricacies of the IF model, a financing transaction is not usually recognised or booked by the IFI until the customer signs the financing contract, be it a *murabahah* or an *ijarah* contract or any other *Shari'ah*-compliant contract. In other words, even of the IFI approves the "finance" application, the transaction is not recognised or booked in the records of the IFI until the customer (or the borrower) signs the relevant contract.

5. CONCLUDING REMARKS

ITSs are considered nowadays a primary pillar for the success of any business, especially financial institutions.

Having effective systems in place is vital to the IF industry, in part because of the complexity of the IF operating model, as this would significantly mitigate the operational risks highlighted above.

Regardless of the fact that the IF industry is still in its infancy and faces major challenges (e.g., standardisation, innovation, and regulation) that it

needs to overcome, the deficiencies of the systems available for the IF industry represent a major threat to the *Shari'ah* compliance of the IFIs, as well as a more general obstacle to the growth of the industry. Such deficiencies require immediate attention and drastic action by the industry itself.

The industry has to fast-track well-orchestrated and well-defined initiatives to develop robust and effective ITSs (or platforms) to assist the IFIs to grow and to address their day-to-day challenges—and most importantly, to mitigate the IT risks they are facing in their day-to-day operations.

Until then, the IFIs can only do their best to work around the current imminent risks and try to find applicable *ad hoc* remedies.

NOTE

1. The same might apply to a largely conventional banking group with Islamic banking subsidiaries.

CHAPTER 9

Law and Islamic Finance: An Interactive Analysis

Yusuf Talal DeLorenzo and
Michael J. T. McMillen

1. INTRODUCTION AND OVERVIEW

One of the most prominent features regarding the development of the Islamic economy in its "modern era" (which begins approximately 1390 AH, or 1971 CE) is the interactive influence of law and Islamic finance. Islamic finance is fertilising the development of law, particularly in its jurisprudential sense. And law, in both its jurisprudential and practical applications, is stimulating and shaping the growth of Islamic finance. This is the theme of this chapter. There is no pretense at comprehensive coverage of these interactive influences; the approach is to discuss only a handful of examples taken from both Islamic *Shari'ah* and secular law.

We begin with an historical analysis of how Islamic finance has influenced the development of Islamic jurisprudence. From little more than a concept in the first decades after most Muslim countries regained their independence following World War II, modern Islamic finance took the form of Islamic banks and investment houses in the 1970s and 1980s, and a growing body of scholarship was generated by the practical needs of those institutions as they began to proliferate, particularly as they accumulated more deposits and the demands for product diversity grew more insistent.

No legal system can remain viable without a subject, and without an object, for its application. In recent centuries, and until the 1970s and 1980s, throughout much of the Muslim world, the only significant finance available to Muslims was what Western commercial banks had to offer: primarily interest-based products. Without active commerce, the *Shari'ah* rules for

Islamic Finance: The New Regulatory Challenge.
Edited by Simon Archer and Rifaat Ahmed Abdel Karim
Copyright © 2013 by John Wiley & Sons Singapore Pte. Ltd.
ISBN: 978-1-118-62897-3

transacting would become no more than a subject of academic concern, like a dead language. Without renewal, without constant attention on the part of qualified jurists to changing circumstances and realities, those rules, like any other system, would atrophy and eventually lose relevance. Islamic banking and finance in the 1970s and 1980s provided the living subject to which Islamic jurists turned their attention.

Given the inherent depth and breadth of classical Islamic commercial law, modern jurists found a veritable ocean of practical and theoretical jurisprudence upon which to draw while confronting the challenges of the modern marketplace. The first few decades of the modern era in Islamic finance may be characterised as a period of revival. The most recent decade has been a period of significant innovation. Using the nominate contracts for trade and exchange as their building blocks, modern Muslim jurists have provided *Shari'ah*-compliant solutions to an ever-expanding spectrum of needs.

Thus, Section 2 of this chapter moves from a consideration of the foundations of Islamic commercial law to the factors that have influenced the evolution of that law in modern times. The rise of modern Islamic banking is examined as a factor that has moved Islamic finance through a period of "revival and recovery" to a period of "transformation and adaptation." The period of revival and recovery was characterised by the presence of relatively few Islamic banks, relatively few *Shari'ah* scholars with knowledge and practical experience in financial and commercial transactions, a focus primarily on the deposit side of Islamic banking, and discourse on Islamic finance primarily in the Arabic language. The current period of transformation and adaptation is characterised by various aspects and conditions: a significant number of Islamic and conventional multinational banks and financial institutions as participants; participation by *Shari'ah*-compliant and conventional asset managers; the development of significant practical experience by Muslim jurisprudents in an expanding range of financial and commercial transactions of increasing complexity; a growing discourse on Islamic finance in the English language; a movement toward consensus among *Shari'ah* scholars (*ijma'*); the acceptance and implementation of the concept that the nominate contracts may be thought of as building blocks, which may be constituted and constructed creatively for the achievement of all manner of objectives; and a transactional base that entails conformity with both the *Shari'ah* and at least one body of secular law. Other factors of particular importance include increasing internationalisation and globalisation as well as the rapid movement to greater breadth and sophistication of Islamic financial products.

Later sections of this chapter move the focus from a general historical review of jurisprudential trends to a detailed analysis of how the practical

application of law influences the growth and development of Islamic finance and the Islamic economy. A primary function of law and legal systems is the provision of transparency certainty and predictability to market participants and the society at large. Contracts constitute a type of private law for individual transactions and groups of transactions.

Thus, the enforceability of contracts is an area of immediate relevance, and one that must be clearly understood. Modern *Shari'ah*-compliant transactions involve both the *Shari'ah* and secular law, with the contribution of each varying from jurisdiction to jurisdiction. Initial inquiry must focus on the issue of how to ensure that the provisions of a commercial or financing transaction that is structured in accordance with, and intended to be compliant with, the principles and precepts of the *Shari'ah* will be enforced by the courts and other enforcement bodies of different jurisdictions, and will be enforced in accordance with the terms of the contract as agreed by the parties to that contract. Consideration must be given to enforcement issues in both (a) those jurisdictions that incorporate the *Shari'ah* in their substantive law and thus will enforce contractual arrangements in accordance with the *Shari'ah* because the governing law will itself include the *Shari'ah* ("*Shari'ah*-incorporated jurisdictions"), and (b) those jurisdictions that take no cognisance of the *Shari'ah* and thus will not enforce it as a matter of governing law but may enforce it as a matter of enforcement of a contract under the governing law of that jurisdiction ("purely secular jurisdictions").

Enforceability is a function of the law of the enforcing jurisdiction. Choice of law issues come to the fore in every jurisdiction given that *Shari'ah*-compliant transactions, and documents that are themselves compliant with the *Shari'ah*, must be enforced in purely secular jurisdictions. A recent English law case, *Shamil Bank of Bahrain E.C. (Islamic Bankers) v Beximco Pharmaceuticals Ltd. and Others*, provides a framework for discussion and analysis of choice of law issues, particularly the choice of the *Shari'ah* as governing law. This case addressed issues of enforcement of the *Shari'ah* in a purely secular jurisdiction (England) where the contracts at issue specified the use of English law as the governing law, subject to the *Shari'ah*.

Thereafter, enforceability is considered in another, distinct analytical framework: the legal opinion on enforceability of transactional documents that is required in essentially every financing transaction. The nature and essential elements of these legal opinions are considered both generally and with respect to *Shari'ah*-compliant transactions. The focus is on the specific legal opinion that the relevant "agreements are valid and binding obligations, enforceable in accordance with their terms."

The chapter closes with consideration of an example of an area in which law has a profound impact on the future of Islamic finance, both as to the

structure of individual transactions and as to the shape of capital markets, particularly secondary markets, and thus the configuration of the entire Islamic finance industry and the Islamic economy. The example that is considered relates to *sukuk* issuances, current and future, and the nature of Islamic capital markets. *Sukuk* issuances can be bonds or securitisations. Both types of issuances access, and help to establish and build, the capital markets. Securitisations, however, have far broader implications. They allow for diversification and pooling of risks. They allow asset originators to manage their balance sheets and their capital structure and increase their productive capacity. And they have a special role in creating and sustaining capital markets—in particular, secondary markets.

Current *sukuk* issuances are primarily Islamic bonds, most frequently bonds that are based upon sovereign credits. As of this writing, true securitisations that are based solely upon the credit of the securitised assets are rare. If the benefits of securitisation are to be obtained for Islamic finance and the Islamic economy, there will have to be continuous issuances of asset-based securitisation *sukuk* by the private sector. That cannot be achieved without having those issuances rated by the major international rating agencies. Obtaining those ratings, in turn, is dependent, among other things, upon obtaining the requisite legal opinions from prominent law firms engaged in these issuance transactions. These legal opinions must address a broad range of critical issues focusing on sale, collateral security, and bankruptcy issues, among others. Thus there is discussion of true sales of assets, non-consolidation of assets, bankruptcy remoteness covenants, collateral security considerations, enforceability of contracts issues, choice of law doctrines, and issues pertaining to the enforcement of judgements and foreign awards. The ability of law firms to opine on these essential matters in many jurisdictions within the Islamic economic sphere (see below) is presently nonexistent or severely limited, with the consequence that capital market and secondary market growth is severely constrained. It will be necessary to address fundamental legal reforms and clarifications in the secular legal realm, as well as greater clarity of applicable *Shari'ah* principles and precepts, if these markets are to be fully developed.

For the purposes of this chapter, (1) there is reference to the jurisdictions and economies, without distinction as to cultural, political, and economic factors, of the Middle East, North Africa, and South and Southeast Asia that have predominantly Muslim populations as the Islamic economic sphere, and (2) the jurisdictions and economies, similarly without distinction, of the remainder of the world in which banking and finance is conducted primarily using an interest-based model are referred to as the Western economic sphere, as well as to *Shari'ah*-incorporated jurisdictions and purely secular jurisdictions.

2. ISLAMIC JURISPRUDENCE IN MODERN TIMES

"The Lawful is self evident and the Unlawful is self evident," the Prophet of Islam (upon him be peace) said to his followers some 14 centuries ago. Then he added. "Yet between the two are matters that may give rise to confusion; not well understood by many people."[1]

In making this statement, the Prophet laid the foundations for the legal system of Islam, generally known as the *Shari'ah*. Since that time, generations of jurists throughout the Muslim world have applied themselves to the explication and interpretation of *Shari'ah* rules. The role of the jurist in Islam has been to focus attention on what is less than self-evident, the gray areas between what is clearly lawful or unlawful, the areas of potential confusion.

2.1 Foundations of Islamic Commercial Law

The *Shari'ah*, literally "the way," is the Muslim's "way of life," the rules that govern how Muslims conduct every aspect of their lives. When Islam is understood to mean "commitment," that means that a life lived in accordance with Islamic norms is a life of commitment; and the *Shari'ah* may be said to be the divine delineation of the life of commitment.[2] Then, if one is truly to live that life, one must come to terms with how that life is actually delineated by the Divine. It is precisely that "coming to terms" that is known in classical Muslim scholarship as *fiqh*, or Islamic jurisprudence.

The *Shari'ah* is also concerned with social justice. In the marketplace, the role of the *Shari'ah* is prominent because the business of earning a living concerns everyone, as individuals, as groups within society, and as citizens of nations and the world. The logic of the relevant Islamic teachings is that everyone will benefit when people earn their living in a wholesome and lawful manner; and social stability is supported by commercial society. Thus, at the core of Islamic finance are religious precepts governing what is good and permitted, or lawful, and what is harmful and forbidden, or unlawful. It is the responsibility of the jurist to help distinguish the one from the other. As markets grow in sophistication, and transactions become increasingly complex, that responsibility becomes more and more challenging.

It may also be helpful to think of the *Shari'ah* as a "shared endeavor." It is shared, in the first place, between God and humankind. God is the Lawgiver, and humans have the responsibility to receive, understand, and observe the Divine law. Humans are also responsible for preserving it, and for endowing it with renewed relevance in changing times and in a variety of settings. So, in this sense, *Shari'ah* is an endeavor shared between jurists and the texts of revelation, through their understanding and interpretation of the meanings of these texts. The same endeavor is then shared

by jurists among themselves, whether through applying themselves collectively to solve a particular problem or through reference to the works of distinguished jurists, both past and present. In the world of modern finance, this endeavour is shared with authorities and experts from the business world, with lawyers from numerous practice areas (often several for a single project), with regulators and their authorities, and, finally, with the investing, transacting, and consuming public.

2.2 Islamic Commercial Law in Modern Times

In recent centuries, over much of the Muslim world, the *Shari'ah* of Islam was marginalised during an interregnum when Islam's social and economic institutions were displaced by Western models. For example, in the Indian subcontinent the British imported their own legal system, leaving little more than what amounted to "marrying and burying" as the legitimate concerns of what they termed "Muhammadan Law."[3] Under those circumstances it is hardly surprising that a century or two later, when Muslims finally gained independence, their own Islamic legal institutions were woefully unprepared to deal with twentieth-century realities. The same was true of Islamic political, educational, and economic institutions. Thus, during that interregnum, it is not surprising that Islamic jurisprudence, with no place to apply its dynamic of *ijtihad*, was relegated to a long confinement in exclusively academic settings. For it to break out of the confines of academia, Islamic jurisprudence required a real subject, a practical and living application, and practitioners who were not only conversant with the classical discipline but were also cognisant and appreciative of the changes the world had undergone in the intervening centuries.

Oil wealth may have provided the real impetus for the revival of the Islamic jurisprudence of commerce and finance. In the decades of the 1950s and 1960s, at a time when newly independent Muslim states were attempting to come to terms with their cultural and religious identities, a handful of Muslim thinkers began speculating on the theoretical foundations of an Islamic economic system, often as an afterthought to their musings about an ideal Islamic state. The state banks of a few Muslim countries held conferences to discuss the subject, a few scholars published papers in journals, and, in general, the interest in the subject was academic. But with the wealth from oil, the petrodollars of the 1970s, a number of banks and investment houses were established with the clear mandate to operate in accordance with *Shari'ah*.[4] This marks the beginnings of modern Islamic finance.

At the time, to be candid, there was little that was clear in regard to banking operations conducted in accordance with the *Shari'ah*; in fact,

Shari'ah and banking seemed particularly unsuited to any sort of collaboration. The Qur'anic prohibition of *riba*, equating in a general sense to interest and predicated on the understanding that money is a measure of value and possesses no intrinsic value of its own, precluded any sort of dealing with banks and banking. Indeed, throughout the Muslim world, the common understanding was that there was nothing lawful about banks. Even employment in banks was shunned in religious circles.

When the new Islamic banks were established, the first matters for consideration were deposits and savings accounts. How might these operate if no interest was to be paid? And, on the other side of the balance sheet, how would the Islamic banks invest and earn returns if no interest was to be earned . . . if interest was not even a part of earnings? How, finally, could the Islamic banks become profitable?[5]

2.3 The Jurisprudence of Revival and Recovery

It was then that the new Islamic banks called upon scholars of the *Shari'ah* for answers. In those early days, there were few scholars with knowledge of finance and banking. The handful of scholars that had published on related subjects were without practical experience, having had no exposure whatsoever to modern banks and financial markets. In many cases, banks retained scholars based solely on their reputations as authors and authorities on Islamic subjects in general; not as experts or authors of works on finance or related subjects.[6] Thus, as in any fledgling industry, there was a period of adjustment and learning. The process was a rewarding one, however, and though there were difficulties, a good deal of progress was achieved. It is possible, and not unfair, to characterise the jurisprudence of this early period, perhaps the first two decades, as the jurisprudence of "revival and recovery." During this period, scholars looked to the past and reestablished meaningful connections between the *Shari'ah* and the practical world of modern commerce and trade. In this undertaking they turned to the vast body of legal literature created by earlier generations, to the rules of commerce in the legal handbooks and glosses, and to the digests of case law or *fatwa* literature. In many cases, the sources they referenced were of their own particular legal schools of thought, *madhahib*, though there appears to have been, early in this process, a general understanding that consideration would have to be given to the opinions and methodologies of at least four major legal schools.

At this time, too, perhaps owing to the extraordinary demands placed upon individual scholars hired as advisers, and partially in order to bring to bear a wider range of legal opinion representing each of the four major schools of classical legal thought, as well as regional and cultural trends, Islamic banks began to establish *Shari'ah* supervisory boards, often with as

many as six or eight members. A collective and inclusive approach such as this was not new to Islamic law, ever a shared endeavor. In fact, the classical schools of legal thought themselves grew out of academies. The Hanafi school, for example (named for an individual, Abu Hanifah), was developed over several decades during which regular assemblies in the city of Kufah were attended by a core group of about 40 scholars from a variety of disciplines. Much the same process took place in Madinah, where Imam Malik presided, in Baghdad and then Cairo where Imam Shafii led similar groups of the learned, and again in Baghdad, over a half-century later, where Imam Ahmad ibn Hanbal became the focal point of still another such academy.[7]

Throughout the formative period of the 1970s and 1980s, *Shari'ah* deliberations on issues related to modern banking were carried out collectively by formally constituted *Shari'ah* boards. Papers were written and discussed, both internally among *Shari'ah* supervisory boards and externally at conferences and seminars. The most important factor in everything that took place at the time, however, was that the jurisprudence had a real subject with which to deal and interact: the growing practice of Islamic finance. The deliberations of *Shari'ah* boards were more than speculation, or theoretical musings, or academic exercises. Real issues were involved and, perhaps more importantly, real people's money—for from the day the Islamic banks first opened for business, they have attracted deposits from average Muslim consumers in addition to their high-net-worth and institutional clientele. For Muslims, the Islamic banks are a godsend, allowing them the opportunity to invest and transact in ways that leave their consciences clear. This has come as a great relief to Muslims the world over; the numbers speak for themselves.

Another factor was at work at the time the Islamic banks opened their doors for business. *Shari'ah* scholarship on financial matters had found a patron. Prior to that time, scholars engaged in the jurisprudence of finance did so on their own and generally as a purely academic pursuit. Orientalists such as Schacht, Udovitch, and Goitein made significant contributions to the knowledge of Islamic commercial law (in particular, with respect to the classical nominate contracts) in the two decades after World War II, and their work motivated and guided a handful of Muslim university students and professors who followed. But Islamic finance now constituted a practical industry, and a growing industry cannot progress if guidance is the result of the random output of a scattered and unassociated group of scholars. The demands of Islamic banks were specific and time-sensitive, and could not be allowed to depend on personal schedules and agendas of academics. Through the establishment of formal *Shari'ah* supervisory boards, whose members were compensated for their efforts, the Islamic banks brought scholarship to bear directly upon the issues of greatest concern to them and, by doing so, enabled a new generation of jurists to acquire

expertise on the subjects of modern banking and finance through research and scholarly exchange.

Then, as a collectivity with incentives, the *Shari'ah* boards of the first Islamic banks set about developing ways and means to facilitate the unique and novel operations of those banks. Their first concern was, and remains, the issue of compliance, *Shari'ah* compliance. However, without a process in place for their deliberations, their beginnings were tentative at best, as the problems before them were complex and challenging.

2.4 Adjusting to Modern Trade and Commerce

To begin with, interest-based Western finance had advanced considerably during the interregnum, while Islamic jurisprudence had remained marginalised and inert. There were no ready solutions to be had from the classical legal literature because, for the most part, the classics never dealt with the sorts of issues facing the modern Islamic banks. Advances in technology facilitated commercial activity such as cross-border investing and correspondent banking on unprecedented scales, while regulatory environments and tax laws led to far greater complexity. The volume of commerce and the rapidity with which it may be accomplished were to have profound effects on legal systems worldwide. The same was true of modern phenomena such as the Industrial Revolution, the rise of consumerism, the proliferation of debt financing and unsecured lending, derivatives, fractional reserve banking, and the abandonment of the gold standard. By the time the modern Islamic banks commenced business in the 1970s, the financial community worldwide had already passed through several stages of legislation and regulatory reform focused on, ultimately, the protection of the consumer/investor. Modern reforms in the laws of the United States (especially in regards to finance, banking, securities issuances, investment activities, and business), for example, included matters restricting the nearly unlimited contracting power of the sort envisioned in the classical law of contract known as the "duties of the common calling." Likewise, modern law had introduced relational torts and expanded understanding of bad faith breach.[8] The complexities of today's financial engineering, as exemplified in over-the-counter (OTC) derivatives, stress existing securities laws. Thus, if modern conventional finance is moving more quickly than the law, it should come as no surprise that modern Muslim jurists discovered themselves confronted by a very steep learning curve when attempting to make sense of the new commercial and financial practices proposed to them by the management of the new Islamic banks in those initial decades.

In addition, there was no code, not even an outdated one, towards which modern *Shari'ah* boards might turn for guidance. The one exception was the

Ottoman code known as *al-Majallah* or the *Majelle*;[9] but it was limited to only one school of jurisprudence. It is the nature of Islamic jurisprudence itself to insist on the freedom of qualified jurists to formulate and hold their own opinions. In fact, the inner dynamic for renewal known as *ijtihad* ensures the relevance of Islamic law to changing circumstances by empowering jurists constantly to revisit points of law and to improve upon them as necessary. However, while there was no such uniform code, there was also no requirement of the immutability of previous determinations. Indeed, Islamic law resembles in many ways the British and U.S. legal systems based on common law, a type of judicial law based upon the interpretations of judges as individual jurists, yet unconstrained by the principle of *stare decisis*, or binding precedent.[10] Thus, while *Shari'ah* board members found themselves in the midst of new and uncharted legal territory, they at least had the freedom to think for themselves. This is a significant point, and one that has been ignored by many academics and others. For, despite all else, the fact remains that scholarship on the *Shari'ah*—however isolated, marginalised, and academic—continued to thrive in Muslim lands. Thus, when the time came to apply serious scholarship to Islamic banking and finance, there was no shortage of scholars with the ability and the training, albeit lacking practical financial experience, to take up the challenge.

In this context, the early *Shari'ah* boards sought help in the classical system of nominate contracts (*'uqud musammat*). These are contracts that are widely known by specific names, such as *murabahah, mudarabah, wakalah*, and *ijarah*. Debates on the provenance of these contracts aside, it is well known that trade and commerce were highly developed in the Arabian peninsula before the advent of Islam.[11] Then, even if the nominate contracts were based on earlier, pre-Islamic models, their real value was that they were widely known and accepted. By insisting that Muslims transact by means of a specific set of well-defined contracts, the *Shari'ah* ensures that all parties have every opportunity to understand their prospective transactions. The classical Islamic system of *mu'amalat* (transactions) is so highly articulated for precisely this reason. While the scriptural foundations of that system may be abbreviated, owing to their delineation of principles rather than specifics, the dynamic of *ijtahad*[12] inherent to *fiqh* has ensured that Muslim jurists, especially *Shari'ah* boards, continue to comment and build upon the theoretical constructs.

2.5 The Significance of Contracts

A further important aspect to the nominate contracts, as with other contracts in sophisticated legal systems, is that they constitute a means for risk allocation and management. To understand this point, think of a

contract as a device for stabilising the uncertainty of the future, risk, by connecting that future to the stability of a known past.

> *. . . the past and the future are to the economy what warp and woof are to a fabric. We make no decision without reference to a past that we understand with some degree of certainty and to a future about which we have no certain knowledge. Contracts and liquidity protect us from unwelcome consequences . . .*[13]

Relatively speaking, it may be asserted that the contracts defined by Islamic law represent solid ground. Indeed, it may also be asserted that the reason the institution of banking did not develop in Muslim lands is that it was simply not needed. The nominate contracts prescribed for trade and business by the *Shari'ah* were recognised and, most importantly, upheld by Islamic courts from Spain to China and the Philippines. Thus, within the framework of the Islamic legal system, held together as it were by a set of prescribed contracts, an Islamic legal system of finance and economics flourished in the Islamic East for centuries. To quote from the work of Nelly Hanna:

> *One aspect of trade in the Middle East that has often been emphasized is that there was no system for advancing funds to merchants—that is, there was no equivalent to the European banking system on which European merchants were heavily dependent—and the lack of such a system supposedly handicapped merchants of the Middle East . . . but the functions of this institution were in part fulfilled through the legal system, which provided a legal framework for the advancing of funds.*[14]
>
> *Thus, the contracts upon which transacting in Islam is based function both to stabilize and to promote. By their very nature, these contracts act as a hedge against uncertainty. In addition, the circumstance of their standardization contributed significantly to the comfort level of investors and entrepreneurs, and allowed Muslims to finance huge projects and international trade without the need for intermediaries such as banks.*[15]
>
> *The variety of purposes to which these contracts were put to use is worthy of special attention especially in view of the fact that so much has been written about the rigidity of Islamic law and its inability to adapt to various kinds of situations. The experience of seventeenth-century merchants who carried out a significant portion of their trade within the framework of the judiciary system gives an entirely different perspective on this matter. Rather than a*

rigid set of imposed laws that were supposed[16] *to have suffocated the business, the commercial documents show a legal system that was adaptable to various kinds of situations.*[17]

2.6 The Nominate Contracts

Despite at least partial disuse of the classical system of Islamic finance during the interregnum, the foundations of that system, the nominate contracts upon which it was predicated, remained well defined. Thus, it was to these that the *Shari'ah* boards of the new Islamic banks turned for guidance. The corpus of classical legal literature on the subject of transactions, and particularly the nominate contracts, is immense. The published literature in Arabic alone runs into several thousands of volumes, and educated estimates gauge the size of the unpublished works preserved as manuscripts in libraries around the world as at least three to four times the size of the published works. It is impossible to know how much has been lost over the centuries. In any case, the important thing is that *Shari'ah* boards were able to reference hundreds of titles, and many thousands of *fatawa*, from earlier centuries. This availability facilitated the jurisprudence of revival and recovery alluded to earlier as characterising the early period of Islamic banking and finance during the decades of the 1970s and 1980s.

The most important factor in the transition from the jurisprudence of recovery and revival to a more proactive and participatory jurisprudence of transformation and innovation was the reconfiguration of the nominate contracts. This process began with the concept that the nominate contracts may be used as building blocks for the constructive and creative achievement of all manner of objectives.[18] From the inception of Islamic banking in the 1970s it was apparent that a certain degree of adaptation was required for the successful application of the nominate contracts in modern finance. For example, in order to make the *murabahah* contract effective in the business of inventory or short-term trade financing, it was necessary to depart somewhat from the classical model by combining a promise to buy on the part of a client with the actual purchase by the bank of goods from third-party suppliers.[19] Then, in addition to the actual *murabahah* contract, a further transaction is appended; the promise to purchase that is made by the client or prospective buyer.[20] This arrangement, however innocent in appearance, actually brought up a host of issues for the early *Shari'ah* boards. Nonetheless, as the needs of modern trade were such that a *Shari'ah*-compliant alternative to trade financing by means of conventional, interest-based financing was required, the classical *murabahah* was transformed into the modern *murabahah li'l-amir bi'sh-shira, murabahah* with an order to purchase that has now become commonplace to Islamic banking.

This is only one of scores, if not hundreds, of such examples of how simple nominates have been linked and reconfigured for the attainment of new objectives.[21]

Another result of the extended hiatus endured by the Islamic jurisprudence of finance is that it lost contact with custom and usage. In the classical system, custom (*'urf*) played an important role. The legal maxim that "all transactions are to be considered lawful as long as they include nothing that is prohibited" went hand-in-hand with custom and mercantile practice in clearing the way for innovation in trade and commerce. However, when the *Shari'ah* boards of the modern Islamic banks began their work in the 1970s, there was no significant *Shari'ah*-compliant trade taking place, and thus no customary practice in regard to it. Second, members of the *Shari'ah* boards, with no more than minimal exposure to modern finance, had little understanding of what was customary among modern financial practitioners. Thus, this all-important factor, too, was missing from the equation.

2.7 Academic and Linguistic Factors

The early work of the *Shari'ah* boards was tentative and, in keeping with the universal bias among jurists toward prudence, clearly conservative. Moreover, as the majority of the *Shari'ah* boards' membership was drawn from the ranks of academics, their work tended toward the academic. Under the circumstances, this was for the best. Seminars and conferences were organised, and papers were presented and debated. Professors directed a handful of graduate students to write on subjects related to *Shari'ah* as it pertained to banking, finance, and commerce. Indeed, in the late 1970s, a team of primarily Egyptian academics began work on the production of a five-volume encyclopedia of Islamic banking that served as an important general introduction for the next decade.[22] The work undertaken at this time, like the scholarly exchanges, was almost exclusively conducted in the Arabic language. The language factor was, and remains, significant, with consequences that are discussed later in this section.

During this initial period of recovery and revival, it is notable that scholars began to reacquaint themselves with the workings of the nominate contracts. The significance of this focus was two-fold. First, the nominate contracts, even in their classical forms (and in the forms they had attained before their development was interrupted), provided immediate solutions to several of the banks' most pressing needs. Second, as scholars and bankers became more familiar with these contracts (or specified ways of transacting), they began coming to terms with how these might be applied in novel ways. Indeed, their facility with the nominate contracts was the key to

the next stage of development in modern Islamic finance. Of course, there were other factors. But this single factor (facility with the nominate contracts), through regular exposure to the day-to-day business of the Islamic banks, is what provided the tools for the breakthroughs that would occur in the decade of the 1990s, and that continue until today.

Before discussing this breakthrough, consider for a moment the issue of language and what it has meant to Islamic finance. There is no denying the merits of the Arabic language or the advantages it brings to those who know it. Even so, from the day the first Islamic banks opened their doors for business, much of that business was conducted in the English language. After all, as the language of international finance, trade, and commerce, it was only natural that English be used in the Islamic banks. However, while management conversed with correspondent banks, counterparties, trading partners, regulators, and legal counsel in English, *Shari'ah* supervision in the initial period was conducted almost exclusively in Arabic. In several of the early *fatawa*, it is clear that the board had given its opinion on the basis of representations made by management; the *Shari'ah* board members themselves did not read the documentation, but relied upon summaries presented to them in translation. The reason for this situation was that *Shari'ah* board members, with a very few exceptions, had no English language capability. To a degree, this remains a problem even today.[23] The important thing is that, in some cases at least, *Shari'ah* boards were simply unable to understand, and therefore unable to comment upon, the details of the subject transactions.

On the other hand, the business and legal professionals who did not speak Arabic had perforce to go to secondary sources to learn about Islamic finance and, in particular, to the jurisprudence of Islamic finance, a particularly inhibiting circumstance. For these professionals, even for those working in the Islamic banks themselves, such as non-Arabic-speaking expatriates, the lack of access to authoritative opinions presented difficulties, with the result that initiatives toward innovation and improvement were slow to come. Product development and process improvement, under such circumstances, became onerous and cumbersome tasks. Without direct access to the *Shari'ah* boards, legal counsel needed to rely on management to translate and summarise their work. Feedback from the *Shari'ah* boards under those circumstances was little better than hit or miss. None of this was conducive to progress. Instead, the Islamic banks appeared to most Western professionals, even to Western academics, to work behind a veil of mystery. If the fundamental principles were understood, the details were not. In fact, until books on the subject began to appear in English and other languages, even the fundamentals were incomprehensible to all but the most dedicated and determined individuals.

2.8 A New Stage in the Jurisprudence of Islamic Finance

Near the end of the decade of the 1980s, however, these situations had begun to change. By this time, Islamic banking and finance had grown far beyond the expectations of even the most fervent among its early supporters. In fact, Islamic finance became recognised as a growth industry; and a number of multinational banks and asset management companies were taking an interest in its development. Within the industry itself, significant developments were afoot. One of the main reasons for these developments was the progress made by Muslim jurisprudents in understanding the business of commerce and finance and in applying *Shari'ah* principles and precepts to it. Another reason was the facility developed by *Shari'ah* boards with the nominate contracts, such that they began to feel comfortable with novel configurations. Other reasons for development included the growing discourse on Islamic finance in the English language. Finally, the academic discourse on the subject had achieved a critical mass and many issues were moving toward consensus, the all-important *ijma'* or general acceptance of the juristic community considered a binding adjudicator (or indicator, *dalil*) in Islamic law.

Undoubtedly, big players, in the form of financial institutions with their human and capital resources, did much to spur the development of Islamic finance. Their influence on the jurisprudence of Islamic finance, however, has been more subtle. Before discussing the innovations made by scholars with respect to the nominate contracts, it will be well to begin with a discussion of how the multinationals and global asset managers helped the jurisprudence of Islamic finance move into a significant new stage of creativity. Certainly a part of this involved the growing facility of *Shari'ah* scholars with English. To a degree, these two factors went hand in hand. Clearly it is true in any profession that it is one thing to acquire experience, and quite another to have exposure to the top echelons of that profession. *Shari'ah* scholars began working closely with Wall Street insiders, with some of the most knowledgeable and talented individuals in the business, and it was then that the exchange of ideas began in earnest. In some cases, a single member of a *Shari'ah* board would take part in such exchanges and report back, formally or figuratively, to his peers on the board. Exchanges of this nature provided *Shari'ah* scholars with valuable, and often key, insights into business procedures and practices that might otherwise have remained obscure and therefore suspect. Nor was this process of exchange a one-way street. On the contrary, as their own understanding of modern business concepts and practices increased, *Shari'ah* scholars were emboldened to make comments of their own, often pointing out parallels that exist between fundamental *Shari'ah* concepts of transacting and modern commercial law;

and then moving on to extrapolate shared concepts and to consider their possible applications in modern situations. Through such exchanges many scholars acquired an insider's grasp of the context of modern commerce. Clearly, such exposure added perspective and depth to the deliberations of *Shari'ah* boards on the jurisprudence of modern Islamic finance. While it may be difficult, if not impossible, to quantify or point directly to such intangibles, it is equally as difficult to deny their influence.

2.9 The Jurisprudence of Transformation and Innovation

As noted in Section 2.6, the most important factor in the transition from the jurisprudence of recovery and revival to a more proactive and participatory jurisprudence of innovation and transformation was the reconfiguration of the nominate contracts or, perhaps more exactly, the concept that the nominate contracts may be thought of as building blocks that may be constituted and constructed creatively for the achievement of all manner of objectives. Section 2.6 discusses the transformation of the classical *murabahah* into the modern *murabahah li'l-amir bi'sh-shira, murabahah* as an example of the application of this concept.

Following the success of this experience, *Shari'ah* boards went on to engineer and approve a host of hybrid nominates, using a single nominate such as *murabahah* in different configurations (such as parallel *murabahah*, reverse *murabahah*, back-to-back *murabahah*, and reverse parallel *murabahah* contracts), or using a plurality of nominate contracts in combination with one another. In this manner, the nominate mainstays of classical Islamic commercial law, *musharakah, ijarah, salam, istisna'a, mudarabah*, and others, were transformed and adapted in a variety of ways to modern needs and circumstances. A case in point is the adaptation of these contracts to bring about interest-free alternatives to conventional mortgages for the financing of homes;[24] in other cases, these became key elements in investment funds, project finance, and, most recently, in *sukuk*.[25] In fact, the contracts for the financing of homes by one U.S. company have recently been securitised and converted to *sukuk* issued by Freddie Mac with all the qualities of U.S. government–secured paper. It would be interesting, as an academic case study, to follow and analyze the transformation and adaptation of all the different nominates applied in that one instrument, as it includes the creative application of many disparate elements.

As discussed earlier, one of the factors in the development of a modern Islamic financial and commercial jurisprudence has been the ability of scholars to communicate their ideas among themselves and, through debate and discussion with colleagues and peers and, to an extent, through demonstrating by means of actual business applications, to bring about general

agreement and approval throughout the scholarly community. The importance of this point, of this process itself, cannot be overemphasised because the concept of *ijma*' as a legal indicator, *dalil*, carries very nearly the same authority as the revelational sources[26] themselves. Whatever questions, reservations, or doubts the critics of modern scholarship may have on this subject, the fact that *Shari'ah* boards have been able to achieve consensus on so many key issues suffices to establish the legitimacy of modern Islamic finance and, more importantly from a practical perspective, sets the stage for the establishment of industry standards, which may, in turn, provide the impetus for real industry growth. Through the efforts of the various academies, especially those with international and regional representation, such as the OIC Fiqh Academy, and through the regular exchanges by scholars at seminars and conferences, particularly those like the annual Albaraka seminars in Jeddah, a serious process has been ongoing since the 1970s.

Finally, with the establishment of the Auditing and Accounting Organisation for Islamic Financial Institutions (AAOIFI) in the early 1990s, the process for bringing scholarly attention to focus on particular issues was streamlined, with the result that consensus could be brought about through an institution, and then regular standards for a wide spectrum of *Shari'ah*-related issues could be approved and implemented. The transparency, thoroughness, and inclusiveness of the process employed by the AAOIFI have contributed in so many different ways to the growth of this industry that it would require a separate paper to do justice to each. Finally, the newly established Islamic Financial Services Board (IFSB) ensures that the efforts of *Shari'ah* scholars and financial and legal practitioners for the achievement of consensus and standardisation will find a place in legal and regulatory systems worldwide.

In the brief span of a few decades, *Shari'ah* scholars across the world have worked together and with others to bring about the revival of one of Islam's most important institutions, its finance. In the process, Islamic jurisprudence has undergone significant development. Moreover, the revival of Islamic commercial energies has led to an expansion of cooperation and mutually beneficial exchanges between Muslims and the other peoples of the world. This can only lead to a better and brighter future for all.

3. ENFORCEABILITY OF THE *SHARI'AH*

As noted in the first sections of this chapter, Islamic finance in the modern era has passed through a period of "revival and recovery" to a period of "transformation and adaptation." To summarise here, the current period of transformation and adaptation is characterised by various adherents and

adherences to *Shari'ah*: by a significant number of Islamic and conventional multinational banks and financial institutions as participants; the participation by *Shari'ah*-compliant and conventional asset managers; the development of significant practical experience by Muslim jurisprudents in an expanding range of financial and commercial transactions of increasing complexity; a growing discourse on Islamic finance in the English language; a movement toward consensus among *Shari'ah* scholars (*ijtna*'); the acceptance and implementation of the concept that the nominate contracts may be thought of as building blocks that may be constituted and constructed creatively for the achievement of all manner of objectives; and a transactional base that entails conformity with both the *Shari'ah* and at least one body of secular law.

3.1 Trends in Islamic Finance and the Focus on Enforcing Islamic *Shari'ah*

Three trends during the period of transformation and adaptation are particularly notable: (1) "internationalisation" and "globalisation"; (2) diversification of *Shari'ah*-compliant financial products and structures; and (3) increasing sophistication of those products and structures. Each of these developments has the effect of focusing attention more immediately and more precisely on the issue of whether the principles and precepts of the *Shari'ah* will be legally enforced in any given circumstance, with respect of any given structure, product or transaction, and in any given jurisdiction. Of course, this is occasioned by the focus of all concerned with *Shari'ah*-compliant transactions, be they seeking such compliance or indifferent to such compliance, with the degree of certainty, predictability, and transparency of the *Shari'ah*-compliant structure, product, or transaction and with the functioning of the relevant legal regimes as risk allocators. Much of the history of commercial law in the United States, England, France, and many other countries that have been successful in promoting commercial interests (and, essentially "exporting" their law as a governing law of commercial and financial transactions) relates to the certainty, predictability, and transparency of the legal system and legal determinations in respect of commercial and financial matters, as well as the principles of risk allocation, fairness, and justice.

The transactional context that focuses on the enforceability of the *Shari'ah* is best examined by considering some illustrative examples of modern transactions. One type of transaction is a *Shari'ah*-compliant transaction in the United States involving the development of a real estate project by a non-Muslim U.S. developer with financing provided by a non-Islamic U.S. bank.[27] A Muslim investor from the Middle East or Southeast

Asia desires to invest in the construction and development of this project in compliance with the *Shari'ah*, and that investor's *Shari'ah* supervisory board will review and pass upon the structure and documentation of the transaction. The investment in, and financing of, the project must comply with the secular law of the relevant state of the United States as well as applicable federal laws of the United States. The developer and the financing bank agree to participate in a *Shari'ah*-compliant transaction structured as an *istisna'a-ijarah*, although neither has any informed knowledge of what these structures entail and despite the fact that documents such as these are unknown, in this type of transaction, in the United States.

Another example is the issuance of *sukuk*, a *Shari'ah*-compliant pass-through securitisation of assets located in a *Shari'ah*-incorporated jurisdiction. The asset originator is located in that same jurisdiction. Assume that the *sukuk* issuer is a special purpose vehicle located in a purely secular jurisdiction that allows for the choice of applicable law for financial transactions. And assume that the *sukuk* are sold to both Muslim and non-Muslim investors throughout the world. The applicable laws will include those of the *Shari'ah*-incorporated jurisdiction, where the originator and the assets are located, particularly with respect to whether there has been a "true sale" of the assets by the originator to the special purpose issuer. The bankruptcy laws of both the jurisdiction where the originator and the assets are located and of the jurisdiction in which the issuer is located will be applicable to the transaction. Further, it is likely that the securities laws of the issuer's jurisdiction as well as those of the various jurisdictions of the purchasers of the *sukuk* will be applicable in certain circumstances.

It is noteworthy that in each of the illustrative transactions, the profit margins are quite thin and, for the most part, non-Islamic transactions of these types are quite standardised in terms of (a) the relative rights and remedies of the parties, (b) the terms of many financial and commercial risk allocations, and (c) the legal documentation. For example, in non-Islamic transactions the same forms of financing documents are used with minimal change from one transaction to the next. These documents have been used for many years and have been the subject of considerable interpretive litigation over the many years. Thus, there is great certainty and predictability as to how any provision will be interpreted or implemented as well as with respect to the rights, obligations, and remedies of all of the parties in a broad range of circumstances.

In the *Shari'ah*-compliant configuration of these transactions, the *Shari'ah*-compliant investor and the *Shari'ah* supervisory board are (of course) not indifferent to the issue of compliance with the *Shari'ah*. In fact, they desire to know with certainty and predictability that the *Shari'ah* will be enforced in this, as in any similar, transaction. The other participants in the

transaction (including developers and financing banks) may well be indifferent towards compliance with the *Shari'ah*, although they will undoubtedly not be indifferent to the effect that compliance with the *Shari'ah* will have on their respective rights, obligations, and remedies, and on the degree of certainty and predictability inherent in the *Shari'ah*-compliant transaction.

In these types of *Shari'ah*-compliant transactions in the United States or Europe, and at the commencement of the transaction, all parties to the transaction have moved away from the state of certainty and predictability to which they are accustomed, and the non-Muslim participants are not close to the degree of certainty and predictability that they must have to enable them to determine whether to consummate the transaction. The *Shari'ah*-compliant investors are likely to be more comfortable with the structure of the transaction at its inception. (It will be an *istisna'a-ijarah* or *sukuk* structure that he or she has worked with previously, and these investors may also be quite familiar and comfortable with the applicable secular law.) The non-Muslim participants will be notably uncomfortable at this time: they will likely not know more than a few material points about the *Shari'ah*, and they will be using a structure that is totally unique to their experience, that is nonstandard, and that is well outside their customary realm of certainty and predictability. Bankers, by nature and training being abhorrent of risks, particularly risks that they cannot control or understand, let alone risks that are unique to their experience, are usually the most uncomfortable participants in the transaction.

Each of the participants in this transaction will look to the "law" governing this transaction to determine whether the agreed-upon rights and obligations of, and remedies available to, each of the parties (that is, the agreed-upon allocations of risks) will be sustained and enforced in a transparent, predictable, and certain manner. A primary function of law, and we include the *Shari'ah* as "law" for the purposes of this chapter, in the commercial and financial realm is to provide certainty and predictability to the greatest possible extent and to sustain and enforce the determinations of the parties in a given transaction with respect to risk allocation and relative rights, obligations, and remedies. These matters are the focus in respect of the enforceability of the *Shari'ah* in Islamic finance.

Of course, predictability, stability, and uncertainty are matters of individual perception based upon the past experience of the individual participants. For a range of reasons, the perceptions of most participants will be based upon financing techniques and structures that have been developed in the Western interest-based economic and legal system. Some of those reasons include (a) the dominance of the Western interest-based economic system over the last few centuries, (b) the predominance of United States and European financial institutions, lawyers, and accountants in the development

and refinement of the most widely used financing techniques, (c) the refinement and exportation of Anglo-American law, (d) the relative infancy of modern Islamic finance, (e) the lack of familiarity with the operation of legal systems in the jurisdictions of the Islamic economic sphere, and (f) the general lack of knowledge of, and familiarity with, the *Shari'ah*. Those perceptions are also influenced by the existence of "standardised" practices and structures, including "standardised" contracts, applicable to many of the activities that comprise a financing. Those standardised practices, structures, and contracts have evolved, have become "standardised," because of the economic efficiencies that they facilitate, particularly with respect to risk allocation, risk coverage, and minimisation of transactional costs. Of course, most of those standardised practices, structures, and contracts were developed in, and have evolved within, a Western interest-based paradigm and reflect little, if any, sensitivity to the principles and precepts of the *Shari'ah*. Similarly, the contracts will be enforced in a legal system that has developed and evolved in response to the needs of an interest-based economic system.

Each of the participant parties will come to the financing transaction bound by their existing institutional perceptions and practices with respect to such matters as risk allocation, risk coverage, underwriting criteria, and accounting treatment. Each must continue to operate within an existing secular legal and regulatory framework, and that framework has probably shaped many of the embedded institutional practices. Each participant party will have strong expectations, based upon past "best practices" within its realm of experience, as to the enforceability of the many contracts that comprise the project financing. Frequently, this means that parties will desire to have the contracts governed by English or New York law, rather than the law of the host country.

Participants in *Shari'ah*-compliant transactions will include parties that proceed from, and are focused on, structures, methodologies, and documents that proceed from a Western interest–based perspective. However, almost by definition, these transactions will also include participants that proceed from a different set of principles and precepts: those embodied in the *Shari'ah*. Thus, in many cases, *Shari'ah*-compliant financings will utilise structures, methodologies, and documents that allow both Muslim and non-Muslim, particularly Western, parties to operate within a sphere of predictability, stability, and certainty that is acceptable to those parties.

Before examining issues pertaining to the enforceability of the *Shari'ah* in the context of modern Islamic banking and finance, it would serve us well to survey the aforementioned trends by way of sketching some recent developments that provide the context of discussion. In focusing on the issues pertaining to the enforceability of the provisions of a commercial or financial transaction that is structured in accordance with, and intended to

be compliant with, the *Shari'ah* by the courts and other enforcement bodies of different jurisdictions, we need to consider (a) the types of jurisdictions in which such a transaction may occur and in which the related contracts may be enforced, (b) the state of the law in respect of enforcement and issues of governing law (particularly in purely secular jurisdictions), and (c) current practices in structuring and documenting such transactions. We examine each of these topics, and this examination includes consideration of the nature of legal opinions that are rendered in connection with such transactions.

3.2 Internationalisation and Globalisation

Prior to the commencement of the modern era of Islamic banking and finance, interest-based banking and finance was dominant throughout the world, including in the Islamic economic sphere. While that remains true to this day as a general statement, this chapter has outlined the post-1970s development of a system of banking and finance that is compliant with the *Shari'ah*. The establishment of these early Islamic banks and financial institutions occurred on an international, but largely regional, basis and focused primarily on transactions between an Islamic bank or financial institution and its local customer base.

Legal systems in the various countries of the Islamic economic sphere were, and are, primarily secular, with exceptions such as those noted later in this chapter. Often, economic and legal structures were and are the product of legislation or royal decree, and some, if not most, of those structures and that legislation is unclear under, or conflicts with, or is contrary to, the *Shari'ah*, even in *Shari'ah*-incorporated jurisdictions. However, most of those legal systems have some provision or conception that the *Shari'ah* is incorporated in the legal structure, frequently as "a" or "the" paramount law or source of law. Thus, there has been, and there remains, some question of whether, in what circumstances, and to what extent, the *Shari'ah* will be enforced in *Shari'ah*-incorporated jurisdictions within the Islamic economic sphere; the issue is joined, albeit quietly, and without the involvement of the Western economic sphere. Further developments during the modern era of Islamic banking and finance have ensured that the focus on enforceability is not now, and will not be, either quiet or isolated, and that the Western economic sphere will be forced to focus on the enforceability issue in tandem with the Islamic economic sphere.

In the mid- to late 1990s and the early years of this century, certain Middle Eastern investors sought to make investments in the Western economic sphere, particularly the United States, in accordance with the *Shari'ah*.[28] Some of these investors were financial institutions and families that

had long made investments in the United States, although many of those previous investments were not made in compliance with the *Shari'ah*, primarily because of the inability to effect, and perceived inability to enforce, *Shari'ah*-compliant transactions in the United States. Other investors were new to U.S. markets. And, as noted in the next section of this chapter, the products, structures, and transactions began rather simply and quickly became both more diverse and more sophisticated.

As an extension of this internationalisation and globalisation, and in response to political events during the period, the next major development began in late 2001, with acceleration in late 2002 and throughout 2003: Middle Eastern investors began to make *Shari'ah*-compliant investments in European jurisdictions on a significant scale. That trend continues to this day.

The salient point is that the making of *Shari'ah*-compliant investments in the United States and Europe was a broad international and more globalised trend. The transactions involved multiple jurisdictions and participants from a broad range of countries and religious, cultural, and legal systems. Many of the transactional participants, including the financing entities in the United States and Europe, had little or no familiarity with Islam or the *Shari'ah*. Yet, to give effect to the desires of the Muslim investors, the legal systems in the Western economic sphere had to address the issue of enforcing contracts in accordance with the *Shari'ah*, and, because of the structure of those legal systems, had to do so within the context of enforcement of conventional secular law, substantive and procedural, in those purely secular jurisdictions.

Of course, the question (a series of questions) is then dramatically posed: How can a *Shari'ah*-compliant investor or a *Shari'ah* supervisory board considering the structure of, or documentation for, a *Shari'ah*-compliant fund or transaction in the Western economic sphere be confident that the *Shari'ah* will be enforced? Can there be a truly *Shari'ah*-compliant transaction at all in the Western economic sphere if the relevant courts in the jurisdiction within the Western economic sphere will be applying the secular law of that jurisdiction in the interpretation and enforcement of the documentation for that transaction? Will a court in a Western economic sphere or a purely secular jurisdiction ever enforce the *Shari'ah*? How would a court in a purely secular jurisdiction within the Western economic sphere know what the *Shari'ah* is with respect to any matter or dispute? How does the injection of the *Shari'ah* into the secular law context affect the certainty and predictability of outcome that is essential to the effective operation of a legal system in a commercial world? Will financial institutions and non-Muslim transactional parties be willing to approve the enforceability of documents in accordance with the *Shari'ah* when they have essentially no knowledge of the *Shari'ah* and no confidence that there will be any contractual or economic

certainty in a transaction where the *Shari'ah* is to be ascertained, interpreted, and enforced by a court in a purely secular jurisdiction within the Western economic sphere that likewise has no knowledge of the *Shari'ah*?

The questions quickly multiply, and are present in virtually every *Shari'ah*-compliant transaction in the international realm, and most particularly, but certainly not exclusively, in purely secular jurisdictions. These are critical questions to business people that desire minimisation of risk, where possible, and depend upon a legal system that supplies certainty and predictability in commercial and financial transactions. The issues raised by these and related questions are exacerbated by the increasing diversification and sophistication of *Shari'ah*-compliant structures and products, particularly in an environment, such as the present environment, in which *Shari'ah* scholars and others involved in Islamic banking and finance do not themselves agree on what is permissible under the *Shari'ah* in respect of innovative, novel, and sophisticated financial instruments.[29]

3.3 Diversification and Increased Sophistication of Products

Internationalisation or globalisation of Islamic banking and finance in the last 35 years has focused *Shari'ah* scholars, financial institutions, Muslim and Western business people, lawyers, accountants, and many others on the issue of the degree of certainty and predictability in *Shari'ah*-compliant transactions in comparison to the known degree of certainty and predictability in a conventional *Shari'ah*–non-compliant equivalent of that same transaction. The diversification of the base of *Shari'ah*-compliant products and the increasing sophistication of those products, all of which are highly "structured," while both in their infancy, have sharpened the focus further and brought to the fore the question of whether potential participants in these transactions will be amenable to spending further significant amounts in the development of *Shari'ah*-compliant structures and products.

The late 1990s saw pioneering efforts in the area of *Shari'ah*-compliant private equity investments in the United States. Those investments continue to this date and in more refined form throughout the world, including in the United States and in Europe. In 1998, Dow Jones obtained a *fatwa* pertaining to the financial tests applicable to *Shari'ah*-compliant investments in equity securities. With the downturn of the equity markets in the late 1990s and early years of this century, various *Shari'ah*-compliant investors moved forcefully in the United States' real estate markets. Investments were made in construction and development projects, first in the residential housing sector and later in commercial and mixed use projects.

During the period from 2001 to the present, there was a significant increase in *Shari'ah*-compliant investment in Europe, particularly pan-European real estate investments. There was also an increase in *Shari'ah*-compliant transactional activity in the United States during this period, although these transactions were done very discreetly, largely because of events in New York and Washington, D.C., in September 2001 and related developments. *Shari'ah*-compliant private equity funds also focused on both North America and Europe. *Shari'ah*-compliant structures for short sales of securities and options trading have been developed, and *fatawa* have been issued in respect of these structures. Efforts are under way to develop *Shari'ah*-compliant structures affecting the economic equivalencies of a range of derivatives. *Shari'ah*-compliant factoring and refactoring structures have been developed and approved by a *Shari'ah* supervisory board.

Notable aspects of developments in Islamic finance include: the increased involvement of conventional Western financial institutions; the expansion of English-language literature on Islamic finance and Islamic jurisprudence; the access of the *Shari'ah* scholars to the principal business participants in the Western economic sphere; and the involvement of the *Shari'ah* scholars, from the very initial stages onward, in the structuring of financial *Shari'ah*-compliant products, including in the Western economic sphere. Early transactions in the United States and Europe were initiated by Middle Eastern or, to a lesser extent, Southeast Asian institutions that desired *Shari'ah*-compliant investments of their own funds and those of their depositors and other customers. The economics of those transactions required the use of leverage. Conventional Western financial institutions were brought into the transactions to provide the necessary leverage. However, the structures and documentation had to be designed in a manner that made the use of that leverage compliant with the *Shari'ah*. For a range of commercial and legal reasons, the only financial institutions that could or would provide the requisite leverage were Western financial institutions, particularly conventional interest-based banks. Those banks rose to the challenge and implemented the *Shari'ah*-compliant structures and documentation, largely because of their relationships with the Western institutions that were involved as developers, equity investors, and fund managers.

As Islamic finance has grown and the number of transactions has both increased and become more visible, Western financial institutions have shifted their focus. In the context of increasing globalisation of their own businesses, they have recognised the size of the Islamic finance market and made a conscious decision to investigate participation in that market, not as a reflexive matter, but as an initiative matter. Their investigation has led them to the conclusion that it is possible, even practical, to develop structures that comply with, and meet the following desires, demands, and requirements: (a) the needs

of their existing clients in the Islamic economic sphere; (b) their desire for global and international expansion and penetration of their own businesses; (c) their product strengths and capabilities; (d) the *Shari'ah*; and (e) local secular legal requirements. Thus, various conventional Western financial institutions are taking the initiative in developing their own Islamic finance programs, and some of these are at the forefront of Islamic finance. These banks desire to play to their own strengths, such as derivatives. Frequently, these strengths are in areas in which there are, at present, no *Shari'ah*-compliant structures. Additionally, these institutions desire products that compete in the conventional as well as the Islamic finance markets. The result is substantial pressure to create a broader range of much more sophisticated financial instruments and products.

3.4 Public Law and Private Law in Different Jurisdictions

Focusing on the concept of the application of the *Shari'ah* to contractual relationships between two or more sophisticated parties to a commercial or financial transaction, and as a general statement, there are two types of jurisdictions: the *Shari'ah*-incorporated jurisdictions and the purely secular jurisdictions. Examples of *Shari'ah*-incorporated jurisdictions include Egypt, Iraq, Jordan, Kuwait, Saudi Arabia, Syria, the United Arab Emirates, and Yemen. Examples of purely secular jurisdictions include the United States, the United Kingdom, France and most European jurisdictions, Japan, and South Korea.

The degree to which the *Shari'ah* has been incorporated into the substantive law of the various *Shari'ah*-incorporated jurisdictions varies considerably.[30] Historically, the Ottoman Empire adopted many aspects of the French commercial code by 1830, and thereafter adopted many other French codes. Civil law remained largely untouched by this Westernisation process despite the compilation of the *Majelle*. The *Majelle* was a codification of civil law following a Western model, but the *Majelle* itself was comprised of, and based upon, the *Shari'ah* as interpreted by the Hanafi school of Islamic jurisprudence. Since 1949, Egypt and Syria have adopted Westernised codifications of certain laws, while retaining the influence of the *Shari'ah* in many substantive areas. In each of these jurisdictions, the *Shari'ah* is expressly designated as a source of law. In Egypt, the *Shari'ah* is to be consulted by a judge after considering the civil code and custom. In Syria, the *Shari'ah* is to be consulted prior to examination of custom, and is thus a true source of law. Similar concepts are found in the Civil Code of 1976 of Jordan. Kuwait and the United Arab Emirates are examples of nations that have incorporated significant portions of the *Shari'ah* into their codes. In certain jurisdictions, such as Saudi Arabia and Oman, there is no civil code and the role of the *Shari'ah* is predominant, including in respect of contracts.[31]

The distinction between *Shari'ah*-incorporated jurisdictions and purely secular jurisdictions is important in addressing the issue of when, and under what circumstances, the *Shari'ah* is an enforceable element of a contract under the laws of a specific nation or jurisdiction.[32]

In the *Shari'ah*-incorporated jurisdictions, provisions of the *Shari'ah* are either (a) literally incorporated into the text of the substantive law of the nation; or (b) incorporated as an interpretive matter by the courts or other enforcement bodies. In either case, a contract that is governed by the law of the *Shari'ah*-incorporated jurisdiction will be enforced in accordance with the *Shari'ah*, to the extent that the *Shari'ah* is so incorporated and applicable, and whether or not the specific substantive legal provisions are referenced in the contract. Thus, in a *Shari'ah*-incorporated jurisdiction the parties cannot by contract alter the applicable *Shari'ah* provisions, nor will it be necessary for the parties to specifically incorporate applicable *Shari'ah* provisions. (They will be incorporated into the contract by operation of law.)

In a purely secular jurisdiction, on the other hand, the governing law, of itself, will not include any of the *Shari'ah*. Sophisticated parties to a commercial financing transaction are permitted to write their own "law" for the transaction, in the form of the contract, and the contract itself is "the law of the land" with respect to that transaction.[33] Thus, if the parties desire to implement the *Shari'ah*, they will have to draft the contract in accordance with, and incorporate, the relevant *Shari'ah* principles. If New York or English law, or the law of any other purely secular jurisdiction, is chosen as the governing law of a contract, the court will enforce that law, and the contract subject to that law, in accordance with its terms. If the contract in question is drafted in accordance with the *Shari'ah* (for example, to include, as text, the relevant *Shari'ah* principle), the New York or English court, applying New York or English law, will enforce the *Shari'ah* provisions. Alternatively, but with less certainty and predictability,[34] the parties to a contract in a purely secular jurisdiction could choose to apply the law of a *Shari'ah*-incorporated jurisdiction, and thereby ensure that the contract would be enforced in accordance with the *Shari'ah* to the extent that the *Shari'ah* is incorporated in, or comprises a part of, the laws of such *Shari'ah*-incorporated jurisdiction.

4. ENFORCEABILITY OF THE *SHARI'AH*: CASE LAW AND TRANSACTIONAL PRACTICE

In analyzing the issues pertaining to enforceability, under the *Shari'ah*, of provisions of contracts in *Shari'ah*-compliant transactions, it is necessary to consider a number of factors, including: (a) existing law, including case law

in common law jurisdictions; (b) current transactional practice relating to the construction and drafting of contracts in *Shari'ah*-compliant transactions in different jurisdictions; (c) current transactional practice with respect to legal opinions; and (d) the matters of certainty and predictability in *Shari'ah*-compliant transactions in different jurisdictions. In considering these factors, this chapter makes the assumptions that the transactions discussed have been structured and documented in accordance with the *Shari'ah* and that such structures and all documentation have been reviewed and approved by a *Shari'ah* supervisory board.

4.1 *Shamil Bank v Beximco:* A Recent English Court Decision

Focusing on enforceability issues in purely secular jurisdictions, such as England, other European jurisdictions, and the United States, litigation of a *Shari'ah*-compliant transaction using the law of the purely secular jurisdiction as the governing law will raise questions of whether, when, and under what circumstances a secular court will apply the *Shari'ah* in interpreting the contracts involved in that transaction. A recent appeals court decision in an English case, *Shamil Bank of Bahrain E.C. (Islamic Bankers) v Beximco Pharmaceuticals Ltd. and Others* ("*Shamil Bank v Beximco*"),[35] focuses on the enforceability issue in the context of a *Shari'ah*-compliant transaction in which the governing law provisions of the relevant legal contracts contained the following language: "Subject to the principle of the Glorious Sharia'a, this Agreement shall be governed by and construed in accordance with the laws of England." This case provides a good starting point for achieving an understanding of how enforceability issues are addressed in a purely secular jurisdiction.

In 1995, two companies in the Beximco group of companies (the "Beximco Companies") executed a *murabahah* agreement (the "1995 *Murabahah* Agreement") with Shamil Bank pursuant to which Shamil Bank advanced funds to the Beximco Companies for the purchase of specified goods. The 1995 *Murabahah* Agreement was guaranteed by two directors of the Beximco Companies and by the parent company of the Beximco Companies (the "Guarantors"). One of the Beximco Companies made several payments under the 1995 *Murabahah* Agreement in accordance with a payment schedule to that agreement. In 1996, the Beximco Companies entered into a second *murabahah* agreement (the "1996 *Murabahah* Agreement") with Shamil Bank, and funds were advanced pursuant to the 1996 *Murabahah* Agreement. The second of the Beximco Companies made various payments to Shamil Bank pursuant to the 1996 *Murabahah* Agreement and its related payment schedule.

By late 1999, both Beximco Companies were in admitted default under the 1995 *Murabahah* Agreement and the 1996 *Murabahah* Agreement

(collectively, the "*Murabahah* Agreements"). In 1999, the Beximco Companies entered into two Exchange in Satisfaction and User Agreements with Shamil Bank, and these were later amended in 2001 and 2002 (as amended, the "*Ijarah* Agreements"). Pursuant to the *Ijarah* Agreements, certain assets of the Beximco Companies were transferred to Shamil Bank in satisfaction of the *Murabahah* Agreements, the Beximco Companies were granted the right to use those transferred assets, and the Beximco Companies agreed to make payments to Shamil Bank in respect of such use. Each of the *Ijarah* Agreements was guaranteed by the guarantors.

Pursuant to the constitutional documents of Shamil Bank,[36] the *Shari'ah* supervisory board of Shamil Bank ascertains that the "investments and activities" of Shamil Bank conform to the *Shari'ah*. The Shamil Bank board of directors has the responsibility, pursuant to the constitutional documents, to "ensure that all the investments and other business transactions [of the Bank] have been referred" to the *Shari'ah* supervisory board. It is not clear from the reported decision whether or not the *Shari'ah* supervisory board of Shamil Bank reviewed the precise transactions, and related documentation, pertaining to the *Murabahah* Agreements, the *Ijarah* Agreements, and the related guarantees. This presumably would be a factual matter to be determined at a trial.

In mid-2002, both of the Beximco Companies were in default under the *Ijarah* Agreements and defined "termination events" had occurred thereunder. Shamil Bank provided notices of default and made claims for approximately US$49.7 million on the *Ijarah* Agreements and the guarantees provided by the guarantors. The lower court awarded judgement to Shamil Bank for approximately US$49.7 million. The lower court determined that it was not necessary to concern itself with *Shari'ah* principles.

The governing law provision of each of the *Ijarah* Agreements reads: "Subject to the Glorious Sharia'a, this Agreement shall be governed by and construed in accordance with the laws of England." The governing law provision of each of the guarantees reads that such guarantee: "is governed by and shall be construed in accordance with English law" (there being no reference to the *Shari'ah*).

The critical issue at the appellate court level, as well as at the lower court level, in *Shamil Bank v Beximco* was whether the governing law clause in the *Ijarah* Agreements required the consideration of the *Shari'ah*. The appellate court, like the lower court, determined that the governing law clause did not require consideration of the *Shari'ah*.

The appellate court opinion begins by noting that an English court must interpret a contract in accordance with the commercial purpose of the parties and the contract, and must thus take cognisance of "the genesis of the transaction, the background, the context, the market in which the parties are

operating" and similar factors.[37] In the instant case, this requires recognition of the fact that the contracts at issue (that is, both the *Murabahah* Agreements and the *Ijarah* Agreements) were intended to provide working capital financing with long-term repayment provisions and were to be binding upon the parties to those contracts. Further, and in accordance with that same principle in respect of commercial purpose, the court noted that "insofar as each of the clauses provides in clear terms that 'this agreement shall be governed by and construed in accordance with the laws of England', the proviso that such provision shall be 'subject to the principles of the Glorious Sharia'a' should be approached on a basis which is reconcilable with the purpose evident from the words which follow, rather than operating to defeat such purpose."[38]

Turning to the governing law issues, the court noted that there can be only one law governing enforceability of the provisions of the contracts at issue. By concession in this case, that law is the law of England and not both English law and the *Shari'ah*. The opinion notes that the Rome Convention has the force of law in the United Kingdom,[39] and that the Rome Convention allows the parties to a contract to choose the law applicable to that contract,[40] but that the law so chosen must be the law of a country.[41] The court also notes that Article 1.1 of the Rome Convention "is not on the face of it applicable to a choice between the law of a country and a non-national system of law, such as the lex mercatoria, or 'general principles of law', or as in this case, the law of Sharia."[42] Concurring with the lower court, the appellate court characterises the *Shari'ah* as a set of "Islamic religious principles"[43] and "religious and moral codes,"[44] rather than laws of a nation.

The opinion then addresses the concept that the law of a nation (such as England) may govern a contract, but that contract may incorporate provisions of another foreign law or a set of rules as terms of the contract whose enforceability is to be determined by such national law. The opinion cites examples that are discussed in a leading text on conflicts of laws, Dicey & Morris, as put forth by the Beximco Companies:[45]

> *32–086 . . . it is open to the parties to an English contract to agree e.g. that the liability of an agent to his principal shall be determined in accordance with the relevant articles of the French Civil Code. In such a case the foreign law becomes a source of law upon which the governing law may draw. The effect is not to make French law the governing law of the contract but rather to incorporate the French articles as contractual terms into an English contract. This is a convenient "shorthand" alternative to setting out the French articles verbatim. The court will then have to construe the English*

contract, "reading into it as if they were written into the words" of the French statute.

32–087 It often happens that statutes governing the liability of a sea carrier, such as the former Harter Act in the United States, or statutes implementing the Hague Rules . . . are thus "incorporated" in a contract governed by a law other than that of which the statute forms a part. The statute then operates not as a statute but as a set of contractual terms agreed upon between the parties. The parties may make an express choice of one law (e.g., English law) and then incorporate terms of a foreign statute. In such a case the incorporation of a foreign statute would only have effect as a matter of contract.

While stating that the foregoing was of no assistance to the Beximco Companies, the court acknowledged the application of the principle that the governing law of a contract may be that of one nation (England or the United States), while "incorporated contractual terms" may come from another body of law or rules (such as the French Civil Code, the Hague Rules or, possibly, and by implication, the *Shari'ah*). However, as noted by the court,[46] such an incorporation concept is only workable "where the parties have by the terms of their contract sufficiently identified specific 'black letter' provisions of a foreign law or an international code or set of rules apt to be incorporated as terms of the relevant contract such as a particular article or articles of the French Civil Code or the Hague Rules. By that method, English law is applied as the governing law to a contract into which the foreign rules have been incorporated."

Turning to the instant case, the opinion finds that the generality of the incorporation of contractual terms, if any, pursuant to the phrase "[s]ubject to the Glorious Sharia'a" is insufficient to identify specific black letter provisions of the *Shari'ah*, and thus ineffective.

The general reference to principles of Sharia in this case affords no reference to, or identification of, those aspects of Sharia law which are intended to be incorporated into the contract, let alone the terms in which they are framed. It is plainly insufficient for the defendants to contend that the basic rules of the Sharia applicable to this case are not controversial. Such "basic rules" are neither referred to nor identified. Thus the reference to the "principles of . . . Sharia" stands unqualified as a reference to the body of Sharia law generally. As such, they are inevitably repugnant to the choice of English law as the law of the contract and render the clause self-contradictory and therefore meaningless.[47]

4.2 Discussion

Before moving to other aspects of enforceability in the context of a *Shari'ah*-compliant transaction, it is worth noting a few aspects of the reasoning in the *Shamil Bank v Beximco* case.

First, in accordance with conceptions of national sovereignty and the concepts of nations, the near universal principle is that the law governing a contract (and most other matters) is the law of a nation as precisely defined in that nation. This law will include both substantive legal principles, such as with respect to the nature of contracts and their interpretation, and procedural laws, such as with respect to how a given claim is brought in the courts of that nation or enforced under the laws of that nation. As noted in this chapter, certain jurisdictions—the *Shari'ah*-incorporated jurisdictions—do incorporate the *Shari'ah* into the national law, either generally or in specific instances. However, even in *Shari'ah*-incorporated jurisdictions, the degree of incorporation varies considerably and is often general rather than specific. As a general, and near universal matter, national law will govern the interpretation of contracts.

Second, the laws of many nations allow the parties to a contract to choose the law that will be applicable to the enforcement of that contract. The Rome Convention that is cited in the *Shamil Bank v Beximco* opinion is one of the most significant embodiments of that principle. In most legal systems, there are "conflicts of laws" and "choice of laws" concepts that address the circumstances in which different governing laws may be chosen and enforced.[48] Again, there are variations in this concept, especially as regards enforcement of foreign judgements obtained in foreign courts or under foreign law and as regards the concept of "public policy" of a given nation as it relates to the structuring and enforcement of contracts.[49]

Third, as a general matter, the laws of many nations allow the parties to a contract to incorporate foreign laws, codes, and rules into a contract governed by the laws of such nation, although they also require some degree of specificity to effect that incorporation. Any such incorporation is usually considered to be an incorporation of specific contractual terms, rather than a modification of the governing law provision itself. The ruling in *Shamil Bank v Beximco* is consistent with those principles. The court in *Shamil Bank v Beximco* implied that it would have no objection to the incorporation of specific aspects of the *Shari'ah*, analogously to incorporation of the French Civil Code, The Hague Rules, or the Harter Act, if there were adequate specificity of the terms to be incorporated. This is consistent with the laws of the States of the United States and of most European jurisdictions.

Fourth, generally the laws of most nations allow the parties to a contract, particularly a commercial contract between sophisticated parties, to

agree to such contractual terms and conditions as the parties determine appropriate. Of course, there are certain limitations, such as those pertaining to illegal acts or acts contrary to public policy, which cannot be the subject of a valid and enforceable contract. Another set of limitations relates to contractual contravention of a paramount law, such as a constitution or the *Shari'ah* itself. Similarly, there are unwaivable and mandatory legal provisions in the laws of most nations, particularly in respect of matters where the sophistication and bargaining power of the parties are disparate. Examples of the latter type of provisions include certain consumer protection, environmental protection, landlord–tenant, and public policy laws that may not be altered or waived by contract.

5. TRANSACTIONAL PRACTICE: LEGAL OPINIONS

Financial transactions are most often determined on the basis of legal opinions concerning parameters of existing laws, enforceability of laws, and certain specialised requirements. Section 5 sets forth three practical scenarios.

5.1 Legal Opinions in Financing Transactions Generally

In almost every financial transaction, including *Shari'ah*-compliant transactions, the parties will require that their counsel or opposing counsel provide a series of legal opinions. One set of legal opinions will address the due formation and valid existence of the participating entities under relevant applicable law. This threshold set of opinions is generally referred to as the "entity authority" set of opinions. Another set of opinions, and those that are the focus of this chapter, will address the validity and binding effect, and enforceability, of the relevant documents. This set of opinions is generally referred to as the "enforceability" or "remedies" set of opinions. An example of an enforceability opinion for a *Shari'ah*-compliant *ijarah*-based acquisition financing transaction in a purely secular jurisdiction (here, New York) is set forth as an Appendix at the end of the chapter.[50]

5.2 The "Enforceability" or "Remedies" Opinion

"A remedies opinion deals with the question of whether the provisions of an agreement will be given effect by the courts."[51] The essence of the enforceability or remedies opinion is that each of the "undertakings"[52] in the contracts to which the client is a party is enforceable under the designated law governing the contracts, and the standard formulation is that "the agreements are valid and binding obligations of the Company, enforceable

against the Company in accordance with their terms."[53] This opinion is customarily delivered at the closing of the transaction, and its delivery is usually a condition precedent to the closing of that transaction.

As noted in the TriBar Report,[54] the remedies opinion covers three distinct, but related, matters:

1. It confirms that an agreement has been formed.
2. It confirms that the remedies provided in the agreement will be given effect by the courts.
3. It describes the extent to which the courts will enforce the provisions of the agreement that are unrelated to the concept of breach.

Exceptions and exclusions to the opinion are appropriate in various circumstances, and those exceptions and exclusions are set forth in the opinion itself. (The Appendix provides examples of a wide range of exceptions and exclusions.) For example, one or more exceptions may be required in respect of the portion of the opinion described in clause (2) above if either (a) under applicable law the opinion recipient will not have a remedy for a breach of any "undertaking" by the other party to the agreement, or (b) a remedy specified in the agreement will not be given effect by the courts under the circumstances contemplated. An example of the latter circumstance is the concept of "specific enforcement" as being a remedy under a contract. As noted in the TriBar Report,[55] this means "as a practical matter, that a court will consider whether to provide specific performance as a remedy" and not that the court will grant specific performance.

The types of "undertakings" to which the remedies opinion relates may be summarised into three groups. The first group (the "obligations provisions") includes those provisions of the agreement that obligate the company to perform an affirmative act, but say nothing about what will happen if it fails to perform those acts. An example from an *ijarah*-based transaction is the requirement in the *ijarah* that the lessee pay rent. As applied to these provisions, the enforceability opinion "means that a court will either require the Company to fulfill its undertakings as written or grant damages or some other remedy in the event of a breach."[56]

The second group (the "available remedies") comprises those provisions that specify a remedy if the company fails to perform particular undertakings. The stated remedies may be affirmatively stated (for example, the requirement to pay liquidated damages) or, more frequently, set forth as the right of a party to take action (for example, reduce the interest of a defaulting partner in a partnership or exercise a put option or sell certain property). "For those provisions, the remedies opinion means that a court will give effect to the specified remedies as written."[57]

The third group (the "ground rules provisions") includes those provisions that establish the basic rules for interpreting or administering an agreement and settling disputes under that agreement. Examples include the statements (which are actually undertakings of both parties) with respect to the choice of governing law, the forum for dispute resolution (for example, the New York courts or by arbitration), the manner in which notices are effectively given or binding amendments effected (for example, in writing), or the waiver of rights (for example, the waiver of the right to jury trial). "Unless excepted from the opinion, these provisions are covered by the remedies opinion, which is understood to mean that a court will give effect to the provision as written and require the Company to abide by its terms."[58]

5.3 Enforceability Opinions in Specialised Financing Transactions

Enforceability or remedies opinions in specialised financing transactions are subject to considerations that are not applicable to other enforceability opinions.[59] The types of transactions that are "specialised financing transactions" are not specified in the TriBar Specialized Financing Report. The examples given are leveraged leases and sale–leaseback transactions, and other transactions that are "reasoned."[60]

A good argument can be made that many *Shari'ah*-compliant transactions in a purely secular jurisdiction should, and would, qualify as "specialized financing transactions" for purposes of the TriBar Specialized Financing Report (and the "Accord," as defined therein, of the American Bar Association). These transactions involve a significant degree of structuring, the use of multiple agreements to effect the structure, the necessity of considering the entire set of project documents and financing agreements as a totality to clearly understand the agreement of the parties, the disregard of certain of the entities involved for the purposes of some laws (such as the disregard of the funding company special purpose vehicle used in many of these transactions as a taxable entity), and multiple characterisations of the transaction. (For example, the tax matters agreement used in many of these transactions will state that the transaction as a whole is a loan transaction from the Facility Agent (lender) to the Project Company (into which the *Shari'ah*-compliant investment is made) for purposes of the federal income tax laws of the United States, and possibly for certain environmental laws allowing a lender a "safe harbor" in financing transactions.)

Because of the similarities of most *Shari'ah*-compliant transactions with the stated concept of "specialised financing transactions" in purely secular jurisdictions, various legal issues in respect of enforceability

should be explicitly addressed as contemplated by the TriBar Specialized Financing Report.

6. *SUKUK*: CAPITAL MARKETS AND SECONDARY MARKETS

Section 6 examines various factors and functions of the area of Islamic finance called *sukuk*, classified in general as either bonds or securitisations.

6.1 Market Functions and Market Factors

Law, in its practical application, has a profound influence on the form of Islamic finance. Most obviously, the influence is felt at the level of individual contracts and the structure of individual transactions. The previous two sections of this chapter have summarised some of those effects. Of even greater significance are the influences of the law, direct and indirect, on the viability and structure of the capital markets, including secondary markets. A particularly poignant case in point relates to an area of Islamic finance that is in its earliest stages of development: the *sukuk*.

Sukuk are of two general types: Islamic bonds and securitisations. Islamic bonds are based upon the credit of an entity that is participating in the transaction, such as the issuer, a guarantor, or another provider of credit support. Securitisations involve a transfer of assets from an originator into a trust or similar special purpose vehicle (SPV) with the issuance of securities by that trust or SPV. Payments on the issued securities (the *sukuk*) are derived solely from the payments received in respect of those transferred assets, rather than any general credit of an issuer or participating party. Thus, securitisations are based upon the credit of the securitised assets. To date, most *sukuk* issuances have been Islamic bond issuances. True securitisation *sukuk* issues are rare, and issues of this type that have been rated by a major international rating agency are nonexistent.

While both types of issuances access the capital markets and are necessary for balanced growth of the capital markets, true securitisations have benefits that transcend those available from bond issuances alone. Securitisations allow, often require, broad diversification of the assets in the securitised pool. The originator of the transferred assets uses the securitisation to manage its balance sheet and capital structure. The originator transfers assets that generate deferred payments and receives an immediate cash payment from the capital markets in respect of that transfer. This enables the originator to immediately generate more assets and results in further diversification of the financing in respect of the transferred assets and access to a broader financing base. The securitisation process allows greater

risk management and liquidity management for all market participants. It facilitates regulatory and conduit funding arbitrage. At a broader market level, the securitisation process has proven itself as a critical backbone of both the capital markets and, in particular, the development, existence, and functioning of secondary markets. Given the immaturity of capital markets and secondary markets in the Islamic economic sphere, and recent enthusiasm for *sukuk* issuances, securitisations, and the legal and structural support for securitisations, should be areas of primary focus for the entire Islamic finance industry.

To develop strong securitisation capability and related secondary markets, significant market depth must be obtained. Program issuers are a critical component, and those issuers must generate considerable volumes on a constant basis. Program issuers should include both governmental organisations and private financial institutions. Historically, governmental and quasi-governmental institutions have been critical to the development of securitisation markets and related viable secondary markets. In the United States, institutions such as FNMA or Fannie Mae (Federal National Market Association), Freddie Mac (Federal Home Loan Mortgage Association), GNMA or Ginnie Mae (Government National Mortgage Association), and SLMA or Sallie Mae (Student Loan Marketing Association), and similar quasi-governmental agencies, have been particularly effective in helping to establish broad secondary markets and in otherwise realising the benefits of securitisation. For example, the participation of these entities in the securitisation markets has helped to develop the relevant legal and regulatory framework, has fostered and overseen the development of standards and standardised documentation, and has helped to generate volume and depth of the markets. Governments and quasi-governmental agencies have acted as regulators, enablers, issuers, and purchasers of securitised instruments and related securities, with profound effects on the capital and secondary markets and the effectuation of monetary policy.

Securitisation in the field of Islamic finance is subject to a range of inhibitors that will need to be addressed and with respect to which structural accommodation is necessary. One such inhibitor is the considerable fragmentation of the relevant markets. These markets are fragmented with respect to, among other factors, (a) countries, (b) currencies, (c) the state of legal and regulatory development, (d) the degree of elucidation of, and agreement on, applicable *Shari'ah* standards, and (e) the operation of both Islamic and conventional interest-based markets in the same space. Another inhibiting factor is the lack of scale in the Islamic finance field at the present time. A third set of inhibitors relates to a range of uncertainties with respect to the legal and regulatory base for

securitisations and capital markets generally. Consider, for example, the state of development of securities laws in many of the jurisdictions within the Islamic economic sphere. And, with respect to fundamental market criteria, the markets within those jurisdictions are underdeveloped and characterised by illiquidity, excessive concentration of risks, and lack of specialisation. Yet another inhibiting factor is the scarcity of human resources, such as qualified *Shari'ah* scholars and experienced financial, legal, accounting, and other professionals of all types.

6.2 Legal Infrastructure: Systemic Factors Pertaining to Enforcement

The general structure of each of the relevant legal systems is of primary relevance to the ability to effect securitisations and thus to the growth and development of capital markets and secondary markets within those capital markets.[61] As noted elsewhere in this chapter, certainty and predictability are essential elements of any legal and financial system, as are transparency and consistency. As a systemic matter, some of the key structural elements that are of relevance are (a) whether the relevant legal system is based upon a system of binding precedents, (b) whether legal and arbitral decisions, and the rationale for those decisions, are published and widely available, (c) whether the judicial structure is responsive to continuity and consistency in the application of judicial precedents, and (d) the time frame for enforcement of remedies within the system.

While these systemic factors are not treated in detail in this chapter, suffice it to say that many of the key structural elements are absent or insufficiently developed in jurisdictions within the Islamic economic sphere. The concept of binding precedent is often totally absent. Decisions are rarely published. In many jurisdictions, each case is considered *de novo* and without regard to other decisions that have been rendered in similar cases. Judges and other adjudicators are afforded wide discretion in determining cases. And the time frame for enforcement is frequently so long that it precludes effective remedies in fast-moving markets such as the capital markets. Each of these factors is frequently cited by international securitisation and capital markets institutions as a reason for their reluctance to engage in capital markets initiatives in the Islamic economic sphere. These are substantial impediments to growth of the securitisation markets (and thus the capital markets, including secondary markets) in these jurisdictions and there should be immediate focus on the removal, or a satisfactory alleviation, of these impediments.

6.3 Legal Infrastructure: Specific Legal Issues

Realisation of the benefits of securitisation for Islamic finance and the Islamic economy will require continuous issuances of asset-based *sukuk* by the private sector. This cannot be achieved without having those issuances rated by the major international rating agencies. Obtaining those ratings, in turn, is dependent upon obtaining the requisite legal opinions from prominent law firms engaged in these issuance transactions. These observations indicate that consideration of the ratings analysis used by the major ratings agencies is a useful paradigm for studying the legal issues that will affect the development and growth of the capital markets, particularly the secondary markets, insofar as those markets are influenced by *sukuk* issuances. The analytical framework and criteria used by the major ratings agencies are well developed and highly refined.[62]

As a generic matter, and in its simplest form, a securitisation involves (i) an originator of assets, (ii) an issuer of the *sukuk* or other instrument, which is a trust or SPV, (iii) a parent of the issuer, (iv) a payor or payors in respect of the assets being securitised, and (v) a purchaser/holder of the *sukuk* or other securities. The originator of the assets transfers, by sale, the assets to be securitised into the issuer. The issuer sells *sukuk* or other instruments to the purchaser and uses the proceeds of that sale to pay the originator for the transferred assets. Over time, the payor or payors make payments to the issuer, who then transfers those payments to the *sukuk* purchaser as the holder of the *sukuk*. The issuer provides collateral security over the assets to the *sukuk* holders to secure the payment of the *sukuk*.

In determining whether and how to rate a securitisation, rating agencies examine (i) the credit quality of the securitised assets (and, at least as a statistical and underwriting matter, the payors with respect to those assets) and any other available credit support, (ii) the structure of the securitisation transaction, and (iii) the legal opinion as to the structure and its key elements. As a general matter, the securitised assets must be isolated for the benefit of the *sukuk* holders. In the simplest case, the critical elements are: (a) that all rights, title, interest, and estate in and to the securitised assets are transferred by the originator to a bankruptcy remote SPV; and (b) that SPV grants a first priority perfected (or perfectible) security interest over those assets to secure payments on the *sukuk* and other claims of the *sukuk* holders.

The foregoing requires careful examination of (i) the transfer of the assets from the originator to the SPV, and (ii) the priority, perfection, and enforceability of the security interests granted in the securitised assets provided as collateral for the benefit of the *sukuk* holders. This examination is

made through review of the documentation and through the obtaining of a legal opinion that addresses all of the transactional issues. Looking to the primary substantive legal opinions,[63] the following are the primary areas addressed by the legal opinions:

a. True sale of the securitised assets.
b. Non-consolidation of the assets in bankruptcy.
c. Bankruptcy remoteness.
d. The collateral security structure.
e. Enforceability of the transactional documents.
f. Choice of law.
g. Enforcement of judgements and awards.

6.4 True Sale

The true sale opinion addresses the issue of whether the SPV that is the issuer of the *sukuk* owns the transferred assets—that is, whether there was a valid transfer. The transfer must be such that it cannot be recharacterised by a court or other body as a secured loan or otherwise avoided in a bankruptcy or insolvency proceeding involving the originator of the assets (such as pursuant to a fraudulent transfer in anticipation of bankruptcy or a preference payment). The bankruptcy or insolvency of the originator should not affect the assets that have been transferred to the issuer SPV. This, in turn, means that the issuer will be able to enforce collection and other rights against the payor without hindrances resulting from the bankruptcy or insolvency of the originator.

Further aspects of the true sale doctrines relate to the nature of the title transferred to the issuer. Many securitisations involve an unperfected transfer of an equitable interest in the assets (in some cases, so as to avoid legal requirements pertaining to notification of the payor). The transfer must then be perfectible at the election of the issuer. *Shari'ah* scholars have differing views on the permissibility of separation of legal and equitable title to assets, and these raise impediments to effectuation of securitisations in certain unperfected transfer structures. If separation of legal and equitable title is not permissible, legal title would have to be transferred in a manner that satisfies all of the applicable perfection requirements (including notification of the payor).

Another aspect of the sale analysis (although technically not having an effect on whether a true sale exists) pertains to whether the assets are transferred free and clear of all prior overriding liens. This also will be considered in the relevant legal opinions and is a critical ratings criterion.

6.5 Non-Consolidation

A second legal opinion analysis focuses on the bankruptcy of two entities: the originator and the parent of the issuer SPV. In brief, the requirement is that the securitised assets held in the issuer will not be consolidated with the assets of the originator or the issuer parent in a bankruptcy or insolvency of either of those entities. The "separateness" covenants discussed in the next section pertain to the non-consolidation opinion as well as to bankruptcy remoteness.

6.6 Bankruptcy Remoteness

Another area of the ratings criteria relates to the remoteness of the bankruptcy of the issuer SPV. The focus is on reduction of the possibility of a bankruptcy of the issuer. The main reason for concern is that, in many jurisdictions, if there were a bankruptcy of the issuer the assets of the issuer would be distributed in accordance with law or a court order rather than in accordance with the contractual arrangements involving the issuer. Further, there would likely be mandatory stay provisions during the pendency of any issuer bankruptcy, which would interfere with timely payment of the *sukuk*. Therefore, the transaction is structured to make initiation of a bankruptcy proceeding against the issuer as unlikely as possible.[64]

The first set of documentary provisions relating to bankruptcy remoteness restricts the purpose and activities of the issuer SPV. This is accomplished by restricting the business purpose of the issuer exclusively to the *sukuk* transaction. Correlative provisions prohibit various activities. Rating agencies frequently require that these provisions be included in both the constitutive documents of the issuer and the transactional documents for the *sukuk* transaction. The required legal opinion will then have to indicate that the constitutive document provisions will be binding upon third parties.

Separateness covenants will be required to further ensure bankruptcy remoteness (as well as nonconsolidation). Most major rating agencies suggest covenants that require the issuer to:

a. Maintain a separate office.
b. Keep separate corporate records.
c. Hold separate board of directors meetings in accordance with specific schedules and legal requirements.
d. Not commingle assets with any other entities.
e. Conduct business in its own name.
f. Provide financial statements that are separate from other entities.
g. Pay all liabilities out of its own funds.

h. Maintain strict arm's-length relationships with parent and affiliated entities.
i. Not issue any guarantees.
j. Use its own stationery, invoices, checks, and other documents and instruments.
k. Not pledge its assets for the benefit of any other entity.
l. Hold itself out as separate from its parent and affiliates.

Securitisation counsel often interprets rating agency guidelines to require that the foregoing covenants be included in the constitutive documents of the issuer as well as the transactional documents.

A number of issues arise with respect to the separateness covenants in a *Shari'ah*-compliant transaction. First, many law firms have taken the position that the separateness covenants should apply to, and be required of, the issuer and, where the securitised asset is an *ijarah* in a *Shari'ah*-compliant *ijarah*-based structure, the funding company lessor and the project company lessee. In such a structure, the funding company is, by intention, a disregarded entity for tax purposes and makes no decisions or determinations of its own accord—it is an entirely passive entity that undertakes a borrowing and acts as a lessor of the property in which a *Shari'ah*-compliant investment is made. In such a structure, many, if not most, of the separateness covenants are not true on their face. Assets of the funding company and the project company are commingled. Frequently, the financial statements of the project company (the entity of substance) are combined with those of the funding company. The funds of the project company are used to pay all liabilities, including those of the funding company. And the assets of the funding company and the project company are pledged to secure the obligations of each and both. Second,[65] if these covenants are included in the constitutive documents, any breach (however minor or immaterial) of the covenants will constitute an *ultra vires* act and the members of the board of directors of the breaching company may be personally liable in respect of that breach. Given that bank officers and other primary market participants are frequently directors of the project company in *Shari'ah*-compliant transactions, there has been significant resistance to securitisation transactions if counsel requires inclusion of these covenants in the constitutive documents of the project company.

Yet another set of provisions to ensure bankruptcy remoteness relates to non-competition and bankruptcy declarations. The originator, investors, credit enhancers, and others agree in the transaction documents not to initiate involuntary bankruptcy proceedings against the issuer. The issuer also provides, in both its constitutive documents and the transaction documents, not to initiate voluntary bankruptcy proceedings.

6.7 Collateral Security Structure

Consideration of the collateral security structure is a critical factor under the ratings criteria, and the subject of legal opinions. The focus is on the security interests provided for the benefit of the *sukuk* holders. Those security interests must be the first priority (there can be no prior claims and no subsequent claims) and perfected (or perfectible). The legal opinions must address the nature of the security interest, the enforceability of the security interest against third parties, and perfection requirements (such as notices, registration, and recordation). The effects of bankruptcy on perfection must also be considered and opined upon.

A number of significant issues arise in jurisdictions within the Islamic economic sphere. First, *rahn* (mortgage and pledge) concepts in certain of these jurisdictions are possessory in nature (pursuant to the *Shari'ah*). This makes perfection a particularly difficult opinion issue in these jurisdictions. Second, in many jurisdictions, including those within the Islamic economic sphere, and without regard to *rahn* concepts, perfection and priority regimes are not well developed. Third, bankruptcy laws and regimes are not well developed in these jurisdictions. To date, law firms have found it impossible to render satisfactory opinions on the priority and perfection in most of these jurisdictions.

6.8 Enforceability of Documents

Ratings criteria require that enforceability opinions be rendered on all transactional documents. As discussed in Section 5, the form of such an opinion is that the transaction documents are valid and binding obligations of the relevant entities, enforceable against such entities in accordance with their respective terms. The nature of the exceptions and qualifications to enforceability opinions in New York are set forth in the Appendix. Those exceptions and qualifications are acceptable within the ratings criteria.

To date, legal opinions in jurisdictions within the Islamic economic sphere have included a number of other, much broader, exceptions and qualifications. These relate to the following:

a. The *Shari'ah* comprises general principles, rather than specific legal requirements, and, as such, it is difficult to ascertain how the *Shari'ah* will be applied in any specific transaction.[66]
b. Different schools of Islamic jurisprudence interpret relevant *Shari'ah* principles and precepts differently, and inconsistently, resulting in similar uncertainties as to application in any given transaction.
c. The lack of uniform statements of relevant *Shari'ah* principles and precepts.[67]

d. The lack of binding precedents and published decisions, further exacerbating uncertainties as to application of even agreed-upon *Shari'ah* principles and precepts.
e. The great degree of discretion in a court in these jurisdictions.
f. The uncertainty of remedies within these jurisdictions.
g. The fact that many of these jurisdictions will not enforce foreign judgements and, even where they will enforce foreign arbitral awards, may infuse the *Shari'ah* into a review of that award pursuant to public policy doctrines.[68]

To date, the rating agencies and the lawyers who have been asked to provide enforceability opinions have been of the opinion that there is insufficient predictability and certainty to permit the rendering of sufficient enforceability opinions in these jurisdictions.

6.9 Choice of Law

Choice of law opinions are also required in connection with the ratings review.[69] The opinion must be to the effect that the choice of law will be upheld as valid by enforcing authorities in at least (a) the jurisdiction whose law has been chosen as governing the transactional documentation, (b) the jurisdiction(s) whose law governs the formation of each of the entities involved in the transaction, and (c) the jurisdiction in which the assets are located. These are complex legal opinions, and any analysis is beyond the scope of this chapter. It is sufficient to say, for present purposes, that the laws of many jurisdictions within the Islamic economic sphere are, at best, unclear as to choice of law principles. Thus, obtaining the choice of law opinions has been difficult and in some cases impossible.

6.10 Enforceability of Judgements and Awards

Another requirement of the ratings criteria is legal opinions to the effect that the judgement of each court or arbitral authority of relevance to the transaction, which will include foreign courts and arbitral bodies, will be enforced in each of the jurisdictions involved in the securitisation transaction. As noted in the previous section, there are numerous involved jurisdictions, and they will vary from transaction to transaction. Some jurisdictions within the Islamic economic sphere will not enforce foreign judgements and arbitral awards. Some will enforce foreign arbitral awards, but not foreign judgements. In some jurisdictions, the extent and degree of enforcement of foreign judgements and awards is not entirely clear.[70]

Particular difficulties arise in connection with *Shari'ah*-compliant transactions. Consider, for example, enforcement of a foreign judgement or award that was rendered or obtained in a purely secular jurisdiction in a *Shari'ah*-incorporated jurisdiction, and vice versa. Will the judgement or award be reviewed *de novo* in whole or in part upon attempted enforcement in the *Shari'ah*-incorporated jurisdiction? Will a purely secular jurisdiction decline to enforce a judgement or award rendered in a *Shari'ah*-incorporated jurisdiction where the basis of the judgement or award is a *Shari'ah* interpretation of terms not included in the relevant contract? Will a court in a *Shari'ah*-incorporated jurisdiction infuse the *Shari'ah* into the foreign arbitral award as a matter of public policy, and pursuant to the public policy exception of the relevant treaties?

Lawyers are uncertain as to the answers to the foregoing, and many other similar queries pertaining to the enforceability of judgements and awards, and the exceptions and exclusions proposed in legal opinions, have rendered those opinions insufficient for ratings criteria purposes.

6.11 Observations

If Islamic finance is to move beyond the issuance of Islamic bonds and into the widespread issuance of securitisation *sukuk*, with realisation of attendant macroeconomic and microeconomic benefits, it is imperative that the issuances be rated by major international rating agencies. Obtaining those ratings will turn on the availability of legal opinions on the various matters discussed in this section. Acceptable legal opinions from major law firms are not currently available due to the lack of transparency, certainty and predictability of legal parameters in jurisdictions included within the Islamic economic sphere. Initiatives should be, and are being, undertaken to examine critical legal parameters, such as the bankruptcy laws of these jurisdictions and the ability to utilise trust structures (particularly in civil code jurisdictions). The Islamic Financial Services Board is taking a lead in this area. Real progress, however, requires the effectuation of systemic legal reform in these jurisdictions, which will not be easily achieved. The composition of the IFSB is ideal for projects of this type as it includes as members a broad range of jurisdictions in which the uncertainties are particularly acute.

7. SUMMARY AND CONCLUSION

This chapter has reviewed some examples of the interaction between law (both the *Shari'ah* and secular law) and Islamic finance. It is clear that

Islamic finance has had a profound effect on Islamic jurisprudence, facilitating the movement from a period of revival and recovery, commencing in the 1970s, to an innovative period of transformation and adaptation that commenced approximately a decade ago. The ability to use the nominate contracts, and hybrids of the nominate contracts, as well as other factors that comprise the current period, will now further drive the development of Islamic finance, particularly the development of a broader and more sophisticated range of products. Another key factor in the current period is the involvement of both conventional Western institutions and *Shari'ah*-compliant institutions in the developing Islamic economic sphere. This trend should result in a logarithmic increase in creativity and sophistication. More importantly, it should also result in enhanced understanding among the peoples of the world and a greater sensitivity to cultural, religious, social, and legal differences.

It is also clear that enforcement of the *Shari'ah* in both the Islamic economic sphere and the Western economic sphere, and in both *Shari'ah*-incorporated jurisdictions and purely secular jurisdictions, will be a matter of increased focus and relevance. An examination of the case law in a purely secular jurisdiction (*Shamil Bank v Beximco*) and of legal opinion practice indicates that the *Shari'ah* can be enforced in all relevant spheres and jurisdictions if (a) the relevant contracts used in the *Shari'ah*-compliant transaction are documented in such a manner as to be compliant with the *Shari'ah* (so as to enable enforcement under applicable secular law without any reference to the *Shari'ah*, whether as a governing law or otherwise), and (b) in other situations, model acts of relevant *Shari'ah* instruments, contracts, and structures are developed so as to allow sufficient specificity for incorporation in English or New York law documents.

While these developments give cause for optimism, the law presents significant hurdles to the further growth of Islamic finance in areas such as capital markets access. Realisation of the benefits of securitisation, macroeconomic and microeconomic, in the field of Islamic finance will depend in part upon obtaining ratings of *sukuk* issuances. Obtaining these ratings depends, in turn, upon obtaining acceptable legal opinions on a range of true sale, collateral security, bankruptcy, and other legal issues. It is clear that the requisite opinions cannot be obtained at the current time given the state of development of these legal areas in many jurisdictions within the Islamic economic sphere. A call for action and legal reform is in order. Hopefully, involved organisations (such as the IFSB and AAOIFI), governments, regulators, financial institutions, lawyers, accountants, and market participants will undertake a study of necessary modifications to these legal regimes and effect necessary reforms to enable the rendering of the legal opinions that will allow for an explosion in the issuance of rated *sukuk* transactions.

Much has been accomplished in the fields of Islamic finance and the jurisprudence of the *Shari'ah*, and in many areas the secular law is conducive to the continuing growth of Islamic finance. But these successes should not deflect attention from the tasks that lie ahead, in particular the reform of secular law in jurisdictions within the Islamic economic sphere in order to bring Islamic finance to the next level of development and sophistication and to allow explosive growth in the Islamic economy. Let us not shrink from this endeavor, as the game, the benefits within the field of Islamic finance, and throughout both the Islamic economic sphere and the Western economic sphere, will certainly be worth the candle.

APPENDIX

Form of Enforceability Opinion:
***Shari'ah*-Compliant *Ijarah*-Based Acquisition Financing in a Purely Secular Jurisdiction**

[Date]
[Name and Address of Financing Agent]
Re: [**Name of *Shari'ah*-Compliant Acquisition Financing Transaction**]
Ladies and Gentlemen:

We have acted as special New York counsel to [name of the "Project Company"], a [limited liability company] organized under the laws of the State of [Delaware], United States of America (the "*Company*"), in connection with the lease transaction evidenced by the documents listed in *Schedule A* hereto (the "*Documents*").

This opinion letter is being delivered in connection with the execution and delivery of the Documents.

We have participated in the preparation, execution and delivery of the Documents. In rendering the opinion expressed herein, we have examined the Documents. In addition, to the extent relevant to our opinion expressed herein, we have examined the originals, or copies certified to our satisfaction, or electronic copies, of such other company records, certificates, resolutions, certificates of public officials and of directors, officers and other representatives of the Company, and agreements, documents and instruments, as we have deemed necessary as a basis for the opinion expressed herein. As to questions of fact material to such opinion, we have, when relevant facts were not independently established by us, relied upon certificates, representations and warranties of the Company and the other parties

to the Documents or of their directors, officers or other representatives or of public officials and assumed the truth and accuracy of all such certificates, representations and warranties.

In our examination of the Documents, we have assumed, without independent investigation, and with your permission:

i. the due execution and delivery of each Document by each of the parties thereto (other than with respect to the Company);
ii. the legal capacity of all natural persons;
iii. the due authority of all persons and entities signing each of the Documents and all related agreements, documents and instruments (other than with respect to the Company);
iv. the genuineness of all signatures;
v. the authenticity of the originals of all agreements, documents and instruments (including certificates) submitted to us;
vi. the conformity to originals of all agreements, documents and instruments (including certificates) submitted to us as copies;
vii. that each party to a Document (other than the Company), and each person or entity controlling or directing the acts, omissions, decisions and determinations of a party to a Document (other than the Company), including the Facility Agent, will at all times act in good faith and in a commercially reasonable manner in the administration and enforcement of the Documents, all related agreements, documents and instruments, and the transactions contemplated by the Documents and such agreements, documents and instruments;
viii. other than with respect to the Company, each of the parties to the Documents has been and will continue to be, and was at the time of execution, delivery and performance of the Documents, duly formed, and is and will continue to be, and was at the time of execution, delivery and performance of the Documents, validly existing and in good standing under the law of the jurisdiction of its formation, and is and will be, and was at the time of execution, delivery and performance of the Documents, in good standing under the laws of the jurisdiction of its formation and each jurisdiction in which the Documents were or will be executed, delivered and performed, and has and will have, and had at the time of execution, delivery and performance thereof, full power and authority to execute, deliver and perform the Documents to which it is or will be a party (including all appropriate corporate, [limited liability company], regulatory and other approvals, including those permitting participation in the transactions contemplated by the Documents in accordance with their respective terms and to hold title to property in accordance therewith);

ix. other than with respect to the Company, the execution, delivery and performance by each of the parties to the Documents have been duly authorized by all necessary action and have not, do not and will not (1) contravene the constituent or constitutive documents of such party or (2) require any governmental or regulatory authorization or other action under, any applicable law, rule or regulation;

x. no consent, approval, authorization, order, registration or qualification of or with any court or other regulatory authority or governmental agency or body is required for the consummation of the transactions contemplated to be taken by the Company or any other party to any Document pursuant to the Documents under the laws of any jurisdiction (other than, with respect to the Company, Government Approvals included within the Applicable Law of the State of New York, United States of America (the "*State of New York*") and the federal Applicable Law of the United States of America);

xi. the execution, delivery and performance by each of the parties to the Documents of the Documents will not violate any requirement of law (other than, with respect to the Company, Applicable Law upon which we opine herein);

xii. that the Documents are the legal, valid, and binding obligations of each of the parties thereto (other than the Company), enforceable against such parties in accordance with their respective terms, and that such Documents have mutuality of binding effect;

xiii. that the Facility Agent is a corporation duly organized and validly existing under the laws of the State of [Delaware], United States of America, and is qualified, to the extent qualification is necessary, and authorized to do business in the State of New York and the State of [name of State of transaction], United States of America; and

xiv. that the provisions of the Lease (*Ijara*) (as defined in Schedule A) which may be governed by the laws of a State of the United States other than the State of New York, if any, constitute the legal, valid, binding, and enforceable obligations of the parties thereto in accordance with the laws of such other State or States, and insofar as the laws of such other State or States may be applicable to any matters opined upon herein, such laws are identical to the laws of the State of New York.

As used in this opinion letter, the phrases "to our knowledge" and "known to us" mean the actual knowledge (that is, the conscious awareness of fact or other information) of lawyers in the firm who have given substantive legal attention to representation of the Company in connection with the Documents. In addition, except to the extent expressly set forth in this opinion letter, we have not undertaken any independent investigation to

determine the existence or absence of the matter in question, and no inference as to our knowledge of such existence or absence should be drawn from our representation of the Company.

We express no opinion as to the laws of any jurisdiction other than Applicable Law.

"*Applicable Law*" means those laws, rules and regulations of the State of New York and the federal laws of the United States of America currently in effect which in our experience are normally applicable to transactions of the type contemplated by any of the Documents, and does not include, and we express no opinion as to: (a) any New York or federal law, or any other law, relating to (i) title to any property (including the Property, as defined in the Lease (*Ijara*)), (ii) liens pursuant to any mortgage, deed of trust or security agreement or other security interests of any type, or the creation, validity, perfection or priority thereof, (iii) pollution or protection of the environment, (iv) zoning, land use, building or construction, (v) the construction, condition or use of such Property, (vi) labor, employee rights and benefits, or occupational safety and heath, or (vii) utility regulation; (b) antitrust laws; (c) tax laws, rules or regulations; (d) state, federal and other securities laws, including the Investment Company Act of 1940, as amended, and "blue sky" laws; or (e) any law, statute, ordinance, administrative decision, rule, regulation, ordinance, code or similar provision of law of any county, city, town, municipality or similar political subdivision or any agency or instrumentality thereof. "*Government Approvals*" means an order, consent, approval, license, authorization, or validation of, or filing, recording or registration with, or exemption by, any New York state court or federal court of the United States of America located in the State of New York, or any governmental body or authority in the State of New York or the United States of America, pursuant to Applicable Law.

Based upon the foregoing and subject to the limitations, qualifications, exceptions and assumptions set forth herein, we are of the opinion that:

1. Each of the Documents constitutes the valid and binding obligation of the Company [enforceable] [capable of enforcement] against the Company in accordance with its terms.
2. Each of the Documents is in proper legal form under Applicable Law, and is capable of enforcement in the State of New York. To ensure the validity and enforceability of the Documents, it is not necessary to register, record, file or notarize any of the Documents with any court or other government authority under Applicable Law.
3. None of the execution and delivery by the Company of, or the performance by the Company in accordance with the terms of, any Document violates or will violate any Law that is applicable to the Company.

4. No Government Approvals are required to be obtained under Applicable Law by the Company in connection with the execution and delivery by the Company of, and the performance by the Company in accordance with the respective terms of, any of the Documents to render the Documents valid and binding obligations of the Company enforceable against the Company in accordance with their respective terms.
5. All required stamp duties, registration fees, filing costs and other charges, payable under Applicable Law in connection with the execution and delivery of any Document have been paid in full or an appropriate exemption therefrom has been obtained.

Our opinion is also subject to the following qualifications:

a. The enforceability of the obligations of the Company under the Documents is subject, in each case, to (i) the effect of any applicable bankruptcy, insolvency, reorganization, moratorium or similar law affecting creditors' rights generally (including, without limitation, laws relating to fraudulent transfers, conveyances, preferences and obligations), (ii) the effect of general principles of equity, including, without limitation, the availability of specific performance or other equitable remedies, and concepts of materiality, reasonableness, good faith and fair dealing (regardless of whether considered in a proceeding in equity or at law), and (iii) applicable laws, rules and regulations that limit the enforceability of provisions releasing, exculpating or exempting a party from, or requiring indemnification of a party for, liability for its own action or inaction in circumstances involving such party's negligence, bad faith or similar conduct.
b. The opinion set forth in paragraphs 1, 2, and 5 is qualified by the requirements of United States federal law and the law of the State of New York requiring registration, filing, recordation or filing, conditions and actions, and duties, fees, costs and other charges in connection with the commencement and continuation of legal and enforcement proceedings generally and those in the course of proceedings appropriate to the introduction of agreements, documents and instruments generally.

We express no opinion herein as to:

A. the enforceability of provisions purporting to grant to a party conclusive rights of determination;
B. the enforceability of rights to indemnification and contribution under federal or state securities laws, rules and regulations and other

circumstances in which the enforceability of such rights may be limited by public policy;

C. the enforceability of waivers by parties of their respective rights and remedies under law;

D. the enforceability of any provision purporting to be or constituting an agreement to agree;

E. the enforceability of any provision purporting to require or requiring the performance of any obligation in contravention of any law, rule, regulation, injunction or other legal requirement that may be in effect at the time such performance is required;

F. except as expressly set forth in this opinion letter, the effect of the law, rule or regulation of any jurisdiction other than the State of New York wherein any party or property may be located or wherein enforcement of any Document may be sought, including any such law, rule or regulation that limits the rates of interest legally chargeable or collectible and any law, rule or regulation pertaining to intellectual property rights in any such jurisdiction;

G. the enforceability of any provision relating to the submission to the jurisdiction of any court where such court does not otherwise have appropriate subject matter jurisdiction over the relevant matter;

H. the enforceability of any provision relating to set-off or to application of any deposit, property or indebtedness;

I. any provision of any Document providing for payments in the nature of liquidated damages except to the extent such payments are reasonable and do not constitute penalties;

J. the effect on the opinion expressed herein of (1) the compliance or non-compliance of any party (other than the Company) to any of the Documents, or any person or entity other than the Company, with any state, federal, foreign or other laws, rules or regulations applicable to it or (2) the legal or regulatory status or the nature of the business of any such party, person or entity;

K. the enforceability of any provision of any Document to the extent such provision provides for the performance by the Company of provisions contained in any other Document or any other agreement, document or instrument that is governed by any law other than Applicable Law;

L. any waiver of rights to assert the applicability of *forum non-conveniens* doctrines or similar doctrines limiting the availability of the courts of the State of New York as a forum for the resolution of disputes, in each case that are contained in the Documents (and we call to your attention that courts of the State of New York and United States of America federal courts sitting in the State of New York could

decline to hear a case on grounds of *forum non-conveniens* or any such other doctrine);

M. the validity, creation, perfection or priority of, or any other matter in respect of, any security interest in any collateral purported to be granted by the Documents or any other agreement, document or instrument;

N. the enforceability of any provision of any Document that requires the Company to perform its covenants and agreements to operate its business in any specified manner that is contrary to Applicable Law; and

O. the availability of equitable remedies.

Our opinion in paragraph 1 as it pertains to the choice of law provision in each Document is rendered in reliance upon the Act of July 19, 1984, ch. 421 McKinney's Sess. Law of N.Y. 1406 (codified at N.Y. Gen. Oblig. Law 5–1401, 5–1402 (McKinney 2001) and N.Y. CPLR 327(b) (McKinney) (the "*Act*"), and is subject to the qualifications that such enforceability (1) may be limited by public policy considerations of any jurisdiction, other than the courts of the State of New York, in which enforcement of such provisions, or a judgement upon an agreement containing such provisions, is sought, and (2) as specified in the Act, does not apply to the extent provided to the contrary in subsection two of Section 1–105 of the New York Uniform Commercial Code (McKinney 1993 & Supp. 2001).

This opinion letter is being furnished only to you in connection with the transactions contemplated by the Documents and is solely for your benefit and is not to be used, circulated, quoted, published, relied upon or otherwise referred to by any other person or entity or for any other purpose or in any other connection without our prior written consent. This opinion letter is given on and as of the date hereof, and we assume no obligation to advise you after the date hereof of facts or circumstances that come to our attention, or changes in laws, rules or regulations that occur, after the date of this opinion letter which could affect the opinion contained herein.

Schedule A

a. the Finance Lease (*Ijara*) and Purchase Option Agreement, dated as of [date], 20_, between [name of the Funding Company], a corporation incorporated under the laws of the State of [Delaware], United States of America (**the "*Funding Company*") and the Company** (**the "*Lease (Ijara)*"**);

b. the Understanding to Purchase, dated as of [date], 20_, between the Funding Company and the Company;

c. the Understanding to Sell, dated as of [date], 20_, between the Funding Company and the Company;
d. the Property Transfer Price and Basic Rent Note, dated as of [date], 20_, from the Company and issued to the Funding Company; and
e. the Managing Contractor Agreement, dated as of [date], 20_, between the Funding Company and the Company.

NOTES

1. This *hadith* was related in nearly all of the major collections, including those of al-Bukharj, Muslim, Abu Daud, al-Tirmidhi, al-Nasa'i, Ahmad ibn Hanbal, Ibn al-Jarud, al-Tabarani, and Ibn Abi Shayhah.
2. Bernard Weiss, *The Spirit of Islamic Law* (Athens: University of Georgia Press, 1992), 18. Note the substitution of "commitment" for Weiss's "submission."
3. There is also the fact that for several centuries the contribution of the Ottoman Empire in the development of Islamic finance was quite limited.
4. The Mit Ghamr project in Egypt in 1963, the Nassar Social Bank in Egypt, the Organization of the Islamic Conference (formed in 1971), the multinational Islamic Development Bank (formed in 1975), and the Dubai Islamic Bank were early examples. See Nicholas Dylan Ray, *Arab Islamic Banking and the Renewal of Islamic Law* (London: Graham and Trotman, 1995); and see Abdullah Saeed, *Islamic Banking and Interest* (Leiden: Brill, 1996), 5–16, for a more detailed discussion of some of the early events in the development of Islamic banking and finance.
5. While the rate of growth of deposits and assets in the first 15 years was described as astounding, a study of this early period points to the "lack of profitable investment opportunities," citing the reliance of the Islamic banks on projects and inventory finance. Ray, *Islamic Law*, 21.
6. Dr. Muhammad Adb al-Ghaffar al-Sharif, "The *Shariah* Supervision of Islamic Banks," paper presented at the *First Conference of Shari'ah Supervisory Boards for Islamic Financial Institutions*, organized by the Auditing and Accounting Organisation for Islamic Financial Institutions (AAOIFI) in Bahrain, October 2001.
7. Muhammad Zahid al-Kawthari, *Fiqh Ahl al-'Iraq wa Hadithuhum* (1970), 56–59.
8. W. D. Slawson, *Binding Promises* (Princeton, NJ: Princeton University Press, 1996), 9–19.
9. This is the well-known work entitled *Majalat al-Ahkam al-Adaliyah*, originally prepared by Ottoman scholars of the Hanafi school of jurisprudence for use throughout the courts of the Ottoman Empire circa 1839 CE/1285 AH. This work was translated into the English language by an accomplished British jurist and scholar of Arabic, Judge C. A. Hooper, and was published in 1936. Long out of print, the work was again published, in installments, by the *Arab Law Quarterly* in 1986.

10. The stories of how the early jurists, such as Abu Hanifa, Malik, Shafii, and Ibn Hanbal, resisted the efforts of the temporal authorities to codify their legal thought, and to impose those codes throughout their empires, are well known in Islamic history.
11. Many Orientalists, even those as recent as Schacht, went as far as to question the relationship of theory in Islamic financial transactions to historical practice. Recent inquiry has put such negativity to rest. In fact, the success of modern Islamic finance is probably the best of all arguments against such assertions. See Ray, *Islamic Law*, 35–36.
12. The meaning of this term, derived from the same root as *hihad*, is the expending of the utmost effort in the exercise of legal scholarship in order to interpret the law, *fiqh*.
13. Peter L. Bernstein, *Against the Gods: The Remarkable Story of Risk* (New York: John Wiley & Sons, 1996), 205. In the passage quoted, Bernstein is summarizing the explanation developed by Kenneth Arrow and Frank Hahn of the relationship between money, contracts, and uncertainty.
14. Nelly Hanna, *Making Big Money in 1600: The Life and Times of Ismail Abu Taqiyya, Egyptian Merchant* (Syracuse, NY: Syracuse University Press, 1998), 54.
15. ". . . one fact is certain, the legal instruments necessary for the extensive use of mercantile credit were already available in the earliest Islamic period." Abraham Udovitch, *Partnership and Profit in Medieval Islam* (Princeton, NJ: Princeton University Press, 1970), 78.
16. The authors refer here to criticism made by Orientalist scholarship.
17. Hanna, *Making Big Money* (1998), 59.
18. In this regard, it will be helpful to note the origins of the derivatives used in modern conventional finance. "In fact, the majority of financial instruments are not revolutionary new instruments. They are merely combinations of older generation derivatives and/or standard cash market instruments." Warren Edwardes, *Key Financial Instruments: Understanding & Innovating in the World of Derivatives* (Upper Saddle River, NJ: Financial Times/Prentice Hall, 2000), 8.
19. While this has become commonplace today, it is interesting to note a reference in the first encyclopedia of Islamic banking, published in 1982, in which a description of a modem *murabahah* is based on a personal conversation with an officer of an Islamic bank. See *al-Mausu at al-Ilmiyah wa'l-'Amaliyah li'l-Bunuk al-Islamiyah*, Vol. V (Cairo: al-Ittibad al-Duwali li'l-Bunuk al-Islamiyah, 1982), 196.
20. In fact, there are two promises inherent to this transaction; the promise of the client to buy from the bank, and the promise of the bank to sell to the client. The entire matter became the subject of much discussion by the scholars at the *First Conference of Islamic Banks* in Dubai in 1979. Their collective *fatawa* approving this arrangement was a significant milestone in the jurisprudence of modern Islamic finance.

21. For a look at more examples, see Abdulkader Thomas, Stella Cox, and Bryan Kraty, *Structuring Islamic Finance Transactions* (London: Euromoney Books, 2005) and the sources cited at footnotes 25 and 27.
22. *Mausu at al-Bunuk al-Islamiyah, al-Ittihad al-Duwali li al-Bunuk al-Islamiyah* (1983). Several of the authors and contributors to that early work are still contributing to the development of the industry with their hard work, devotion, and invaluable experience.
23. For example, as Islamic investors move into the real estate markets of Asia and the European Union, asset managers, legal counsel, and *Shari'ah* scholars are challenged with documentation in several different languages, sometimes for a single transaction!
24. Brief descriptions of how all three of these nominates have been adapted to form the basis of different home financing programs may be found in Abdulkader S. Thomas and Virginia B. Morris, *Guide to Understanding Islamic Home Finance* (New York: Lightbulb Press, 2002).
25. See Nathif J. Adam and Abdulkader Thomas (eds.), *Islamic Bonds: Your Guide to Issuing, Structuring and Investing in Sukuk* (London: Euromoney Books, 2004), Micheal J. T. McMillen, "Islamic Capital Markets: Developments and Issues," *Capital Markets Law Journal* 10 (2006), 1093/cmlj/km/015, and Michael J. T. McMillen and Abradat Kamalpour, "An Innovation in Financing—Islamic CMBS," in *Commercial/Mortgage—Backed Securitization: Developments in the European Market*, ed. Andrew V. Petersen (London: Sweet & Maxwell Ltd., 2006), 382–412. The material in Section 6.1 is addressed in detail in Commercial CMBS.
26. These, of course, are the texts of the Qur'an and the *Sunnah*.
27. See Michael J. T. McMillen, "Islamic *Shari'ah*-compliant Project Finance: Collateral Security and Financing Structure Case Studies," *Fordham International Law Journal* 24 (1184): 1237–1263, describing the first such transactions in the United States [hereafter, McMillen, "Project Finance Structures"]. See, also, Michael J. T. McMillen, "Islamic *Shari'ah*-compliant Project Finance: Collateral Security and Financing Structure Case Studies," *The Proceedings of the Third Harvard University Forum on Islamic Finance: Local Challenges, Global Opportunities*, pp. 111–131 (2000). Modifications of this type of structure and their use in various transactions is discussed in Michael J. T. McMillen, "*Shari'a*-compliant Finance Structures and the Development of an Islamic Economy," *The Proceedings of the Fifth Harvard University Forum on Islamic Finance: Islamic Finance: Dynamics and Development*, 89–102 (2003). Other illustrative developments are discussed in Michael J. T. McMillen, "Islamic Finance Review 2005/2006: A Year of Globalization and Integration," and Michael J. T. McMillen, "Raising the Game of Compliance: People and Organizations," each in *Euromoney Islamic Finance Year in Review 2005/2006* (2006). Other transactions are discussed in Michael J. T. McMillen, "Structuring the *Shari'ah*-compliant Transaction Involving Non-compliant Elements," paper currently in publication by *Euromoney* as a chapter in a forthcoming book, and in Michael J. T. McMillen, "Structuring *Shari'ah*-compliant Transactions Involving

Non-compliant Elements: Use of the Nominate Contracts," a paper presented at the Islamic Financial Services Board conference, *Islamic Financial Services Industry and the Global Regulatory Environment Summit 2004*, May 18–19, 2004, in London.

28. See, for example, McMillen, "Project Finance Structures," 1237–63. These early transactions were described in the press: Michael J. T. McMillen, "Special Report U.S. Briefing: Islamic Finance: Breaking the Mould," 38 *Middle East Economic Digest (MEED)*, September 22, 2000, 28–29.
29. There is widespread, and spirited, debate regarding the "need" for standardization in the Islamic finance field. This is certainly not a new debate for Muslim jurisprudents: witness the intellectual rigor of the debate over the centuries among Islamic jurists of even the four main schools of *Sunni* Islam: the Hanafi, Han-bali, Shafi'i, and Maliki schools. Recent English-language works that highlight this debate, by way of a comparison of the positions of the different schools of Islamic jurisprudence with respect to specific matters, are Frank E. Vogel and Samuel L. Hayes, III, *Islamic Law and Finance: Religion, Risk and Return* (Leiden: Brill, 1998), and *Financial Transactions in Islamic Jurisprudence, Dr. Wahban Al-Zuhayli's Al-Fiqh Al-Islami wa 'Adillatuh (Islamic Jurisprudence and its Proofs)*, translated by Mahmoud A. El-Gammal (2003), which is a translation of Volume 5 of *Al-Fiqh Al-'Islami wa 'Adillatuh*, fourth edition (1997) and appears in two volumes. For examples of the current debate with respect to the need for standardization on a broader scale within the Islamic finance industry one need only attend any of the many Islamic finance conferences. See also Majid Dawood, "Scholastic Congestion," *Islamic Banking and Finance* 3 (2004): 10–11.
30. For a review of the extent to which, and the manner in which, the laws of various Middle Eastern nations are composed of, or incorporate, the *Shari'ah*, and the extent to which other legal principles are incorporated in the laws of such nations, see Nayla Comair-Obeid, *The Law of Business Contracts in the Arab Middle East* (London: Kluwer Law International, 1996), particularly Chapter 3. The discussion in this section, to the extent that it addresses the integration of the *Shari'ah* into the law of the various nations, is based in part upon this secondary source. See Noel J. Coulson, *Commercial Law in the Gulf States* (London: Graham and Trotman Ltd., 1984). See also Noel J. Coulson, *A History of Islamic Law* (Edibirgh: University of Edinburgh Press, 1964) and Joseph Schacht, *An Introduction to Islamic Law* (Oxford: Clarendon Press, 1964), as general histories of Islamic law.
31. The Kingdom of Saudi Arabia recognizes the *Shari'ah* as the paramount law of the land. However, the various enforcement mechanisms that have been established with respect to the resolution of certain commercial disputes do influence the application of the *Shari'ah* to such disputes. One example is the settlement of disputes between a bank and its customer in Saudi Arabia. The "settlement" of such matters (other than in respect of negotiable instruments) is effected by the Banking Disputes Settlement Committee of the Saudi Arabian Monetary Agency (customarily known as the SAMA Committee), and the

SAMA Committee generally attempts to settle a matter in accordance with the agreement of the parties. Another example in Saudi Arabia is indicated by the jurisdictional authority afforded to the Office of the Settlement of Negotiable Instruments Disputes (NIO), under the aegis of the Ministry of Commerce, which addresses and settles disputes involving negotiable instruments and generally looks only to the "four corners" of the instrument to which the dispute relates. See McMillen, "Project Finance Structures," 1195–1203.

32. For the purposes of this chapter, the distinctions between the various *Shari'ah*-incorporated jurisdictions are ignored unless otherwise indicated.
33. Assuming, of course, that the contract does not violate public policy or fall foul of other mandatory legal requirements.
34. See, for example, some of the incorporation and choice of law requirements that are discussed or referred to in *Shamil Bank of Bahrain E.C. (Islamic Bankers) v Beximco*, as discussed in Section 4 of this chapter.
35. *Shamil Bank of Bahrain E.C. (Islamic Bankers) v Beximco Pharmaceuticals Ltd. and Others* [2004] EWCA Civ 19, [2004] All ER (D) 280 (Jan), January 28, 2004.
36. *Shamil Bank v Beximco*, at para. 7, quoting clauses 35 and 36 of the Articles of Association of Shamil Bank.
37. *Shamil Bank v Beximco*, at para. 46, quoting Lord Wilberforce in *Reardon Smith Line Ltd v Yngvar Hansen-Tangen* [1976] WLR 989 at *996*.
38. *Shamil Bank v Beximco*, at para. 47.
39. *Shamil Bank v Beximco*, at paras. 40 (relating to the lower court decision) and 42 and 43 (noting that the Beximco Companies accept the principle of a single governing law based upon the Rome Convention). The Rome Convention has the force of law in the United Kingdom by virtue of section 2(1) of the *Contracts (Applicable Law) Act* of 1990, as stated in para. 40 of *Shamil Bank v Beximco*.
40. *Shamil Bank v Beximco*, at para. 48, citing Article 3.1 of the Rome Convention ("a contract shall be governed by the law chosen by the parties"). Paragraph 40 summarizes the similar finding of the lower court.
41. *Shamil Bank v Beximco*, at para. 48, citing Article 1.1 of the Rome Convention ("the rules of this Convention shall apply to contractual obligations in any situation involving a choice between the laws of different countries"). Paragraphs 40, 42, and 43 summarize the lower court's similar finding on this issue of interpretation.
42. *Shamil Bank v Beximco*, at para. 48.
43. *Shamil Bank v Beximco*, at para. 54. See, also, *Shamil Bank v Beximco* at para. 40 with respect to the characterization of this matter by the lower court.
44. *Shamil Bank v Beximco*, at para. 55. See, also, *Shamil Bank v Beximco* at para. 40 with respect to the characterization of this matter by the lower court.
45. *Shamil Bank v Beximco*, at paras. 50–52, citing Dicey & Morris, *The Conflict of Laws*, thirteenth edition, Vol. 2, at 32–086 and 32–087.
46. *Shamil Bank v Beximco*, at para. 51.
47. *Shamil Bank v Beximco*, at para. 52.

48. The United States is a federal union, today comprising 50 separate states (including four commonwealths), a federal district (where the capital, Washington, DC, is located), and five major overseas territories, each having a separate and distinct legal system and set of substantive laws and which operate in a system of "parallel sovereignty" with the fedral government. Conflicts of laws issues are thus a daily matter of significant import and consequence in contractual matters in the United States or involving the law of any of the component jurisdictions of the United States. This governmental structure is one of the factors that led to the creation of the National Conference of Commissioners on Uniform State Laws in 1892, with a primary purpose of obtaining a degree of uniformity in the laws of the various states, thus enhancing commerce between and among the States and the certainty and predictability of legal enforcement in different state jurisdictions. Neither the National Conference of Commissioners on Uniform State Laws nor the federal government has the power or authority to prescribe uniform laws among the States; adoption of such laws is a matter of state discretion and prerogative. The success that has been achieved by the National Conference of Commissioners on Uniform State Laws in achieving a degree of uniformity, and in providing methods of defining and tracking differences where there is not uniformity, is an important basis for a proposal previously made by Mr. McMillen to the effect that "model laws" be prepared for each of the main contracts used in Islamic finance. See Michael J. T. McMillen, "'Enforceable in Accordance with Its Terms': A Proposal Pertaining to Islamic *Shari'ah*," Fourth Meeting of the Council and Second Meeting of the General Assembly of the Islamic Financial Services Board, Bali, Indonesia, 2 Raby' al-awal 1425 H.E., April 2, 2004 C.E. ("McMillen, 'IFSB *Shari'ah* Enforceability Proposal"'). The Government of Canada, which comprises 13 provinces and territories and a federal government, and the European Union, among others, grapple with similar, if less extensive and frequent, conflicts of laws issues.
49. See, for example, McMillen, "Project Finance Structures," 199 *et seq*. and sources cited therein.
50. McMillen, "IFSB *Shari'ah* Enforceability Program," addresses issues relating to legal opinions in *Shari'ah*-incorporated jurisdictions as well as those provided in purely secular jurisdictions. Discussions of the former have been omitted from this paper.
51. "Third Party 'Closing' Opinions: A Report of the TriBar Opinion Committee," *Business Lawyer* 53 (1998): 619–621. This report is referred to in this paper as the "TriBar Report." See, also, "Special Report by the TriBar Opinion Committee: Use of the ABA Legal Opinion Accord in Specialized Financing Transactions," *Business Lawyer* 47 (August 1992): 1719–1730, which is referred to as the "TriBar Specialized Financing Report." And see "Third-Party Legal Opinion Report, including the Legal Opinion Accord, of the Section of Business Law, American Bar Association," *Business Lawyer* 47 (November 1991): 167, at Section 10, "The Remedies Opinion," and the definition of "Remedies Opinion" in the glossary thereof.

52. The TriBar Report notes that *all* undertakings in the agreements with respect to which the enforceability opinion relates are covered by the opinion. "TriBar Report," 621. The TriBar Report, at footnote 69, notes that coverage of all undertakings is based upon New York custom and practice, and that not all jurisdictions so interpret opinions. The variance noted in such footnote 69 is that of the "1989 Report of the Committee on Corporations of the Business Law Section of the State of California Regarding Legal Opinions in Business Transactions," *Business Lawyer* 45 (1990). That report endorses a narrower definition of the scope of the enforceability opinion, limiting the coverage of the opinion to only "material" provisions of the agreements that are the subject of the enforceability opinion. It is important to be familiar with the scope of the enforceability opinion in the governing law jurisdiction.
53. See the relevant opinion language in the Appendix.
54. "TriBar Report," 620.
55. Ibid.
56. Ibid., 621. Note that a "representation" in a contract is not an "undertaking."
57. Ibid. If the remedy is one that a court in the governing law jurisdiction will not enforce, the opinion will, and must, make an exception for the enforcement of that remedy.
58. Ibid., 621.
59. See the TriBar Specialized Financing Report.
60. Ibid., 1726.
61. This chapter does not consider the important topic of the regulation of capital markets activities, such as securities issuance, standards applicable to investment companies, capital adequacy standards, prudential standards, trading activities, brokerage activities, and market manipulation regulations. See Commercial CMBS for a discussion of these topics.
62. Other areas of the legal infrastructure are not considered in this chapter, largely because of the tremendous diversity over different jurisdictions. These areas include tax law, real estate law, competition law, and corporate law, among many other areas of applicable law.
63. Entity organization opinions are critical, and are obtained, but are not discussed in this chapter. These opinions address formation of relevant entities, due authorization of the transaction by all entities, and due execution and delivery of all documentation.
64. In addition to bankruptcy remoteness provisions discussed in the text of this chapter, there are also requirements for provisions limiting recourse for payments and indemnities to only the securitized assets (and applicable credit enhancements), provisions mandating that the priority of payments set forth in the documents shall govern in all cases, and provisions to the effect that, after full realization on all securitized assets (and credit enhancements), all payment and indemnity claims are extinguished. These provisions are not further discussed.
65. And this is not specific to *Shari'ah*-compliant transactions.
66. Consider, for example, Section 4 and the *Shamil Bank v Beximco* case discussed in that section with respect to exceptions noted in clauses (a) through (c).

67. See McMillen, "IFSB *Shari'ah* Enforceability Proposal."
68. See the discussion of enforcement of foreign judgements and awards at McMillen, "Project Finance Structures," 1199–1203, and the sources cited therein.
69. Consider the discussion at Section 4 and the *Shamil Bank v Beximco* case discussed in that section.
70. See McMillen, "Project Finance Structures," 1195–1203, and the sources cited therein, for a discussion of enforcement mechanisms in the Kingdom of Saudi Arabia.

CHAPTER 10

Legal Risk Exposure in Islamic Finance

Andrew White and Chen Mee King[1]

1. INTRODUCTION

In the post-crisis environment of the past few years (since 2007–2008), risk avoidance and the management of risk have both become an increasingly prominent feature of the finance landscape. Financial institutions and regulators are today much more sensitive to the various potential areas of risk and, especially, risk contagion. At broader industry levels, this has led to new accounting standards and requirements for capital adequacy, liquidity, and leverage. Within individual financial institutions, better risk analysis and management mechanisms are being implemented, and even structural changes are occurring as many financial institutions recognise the need for risk management to move from a "back office" function often loosely parked within the credit unit, to a "middle office" function with a unified and more clearly defined enterprise-wide responsibility for not only credit risk but also operational risk, liquidity risk, market risk, legal risk, and myriad other risk exposures.

Islamic financial institutions, especially when structured and conducting business as an analogue to conventional financial institutions, face the same threshold risk/return concerns as conventional financial institutions. But as Islamic financial institutions, they also have additional unique risk concerns arising from ensuring their operations (including risk management mechanisms), investments, and products are *Shari'ah*-compliant (or even, optimally, *Shari'ah*-based). Many of these include *Shari'ah* risk (i.e., risk of non-compliance), generally, and more particularly, fiduciary risk and

Islamic Finance: The New Regulatory Challenge.
Edited by Simon Archer and Rifaat Ahmed Abdel Karim
Copyright © 2013 by John Wiley & Sons Singapore Pte. Ltd.
ISBN: 978-1-118-62897-3

displaced commercial risk arising from exposure to possible rate of return disparities from higher prevailing market rates. Further, even within each conventional risk category, Islamic financial institutions face unique risks arising from the nature of *Shari'ah*-compliant operations and products. Credit risk for an Islamic bank, for example, is complicated by, among other concerns, *Shari'ah* principles that limit the remedies available to an Islamic bank in the event of (especially non-willful) default, insolvency, and other scenarios in which a counterparty fails to perform its obligations. Similarly, another significant risk area for Islamic banks, liquidity risk, is exacerbated substantially by prominent *fiqh* rulings circumscribing the use of asset securitisation by Islamic banks and, at least for the present and the immediate future, difficulties in raising funds quickly from existing money markets or LOLR (lender of last resort) facilities typically available to conventional banks unfettered by prohibition of *riba*.

2. DEFINING LEGAL RISK

Legal risk also is considerably more complicated in the context of Islamic finance than in the conventional finance space. In broad terms, this is partly because of the absence of mature legal frameworks and relatively untested legal documentation governing this still-nascent industry, and partly because of continuing uncertainty about *Shari'ah* and secular legal principles to be applied in construing and enforcing Islamic legal documents. While legal risk for Islamic financial institutions arises in the same context of credit risk, operational risk, market risk, and other risks that confront conventional financial institutions, Islamic financial institutions also face risk exposures arising from secular laws and legal-political systems that do not support (or may even be hostile to) the *Shari'ah* and *fiqh* principles[2] that govern Islamic finance; the absence of standardised legal documentation across the industry and limitations on the terms that can be included in contracts; and the absence of meaningful dispute resolution frameworks in most jurisdictions in which Islamic finance is growing.

Stated in its simplest terms, the legal risk to which a party to a transaction is exposed is the risk that either the transaction will not be enforceable against a counterparty, or that any of the transaction's terms will not be construed in accordance with the intentions of that party to the transaction. The party exposed to legal risk may be, for example, a financial institution or an investor in a *sukuk* securitisation. As with other risk exposures, legal risk does not stand alone in a financial institution's risk avoidance and mitigation framework. Most prominently, it is co-related to credit risk and market risk, for example, in that legal risk generally does not arise until

a counterparty has either defaulted in payments or has lost a significant amount of money invested in a transaction. That is, once either the financial institution or the counterparty has incurred a significant loss, the next step taken by the parties is almost invariably to analyse their respective legal rights and obligations, in the context of applicable laws (including the *Shari'ah*) and regulations, as well as the contract documents, and in turn, to seek redress in an appropriate forum.

3. GREATER RISK FROM UNCERTAIN AND UNDEVELOPED LAW AND REGULATION

All financial institutions encounter legal risk exposure in the face of applicable laws and regulations. There may be uncertainty or dispute as to which law governs a cross-border transaction, for example, especially if the parties have failed to clearly state a choice of law (such as, most commonly in finance, New York law or English law). In addition, the governing law of the transaction may simply not support the legal position taken by the financial institution. Moreover, there may have been a failure of compliance with applicable regulations governing the transaction or, even more broadly, the institution.

In the context of Islamic finance, more risk exposure is introduced by application of the *Shari'ah* as an additional governing law, either explicitly stated in the contract or implied from *Shari'ah* compliance as a condition of all Islamic finance transactions. The *Shari'ah*, of course, is not a national law and its inclusion in a contract's governing law provision risks nonenforcement by a secular court, especially, either as a matter of international law such as the Rome Convention,[3] or as a matter of national public policy considerations that disfavor religious law, particularly in a commercial context.[4] The *Shari'ah* and *fiqh* principles are difficult to deduce, and despite centuries of intellectual struggle by even the most brilliant *mujtahidun* and *fuqaha'*, they remain subject to variations in interpretations and differing expert opinions across the various *madhahib* and among prominent *Shari'ah* scholars, particularly when applied to modern finance. Finally, the body of finance law that applies to Islamic finance remains relatively immature, as compared to both common law and civil code jurisprudence that has developed somewhat unimpeded over the past 500 years or more. Modern Islamic finance generally got its start in the mid-twentieth century, and virtually all Islamic finance institutions and products in the market today have been created only in the past 30–40 years.[5] Hence, there is a dearth of common law precedent and civil code jurisprudence that directly relates to Islamic finance as compared to conventional finance.[6] Moreover, most contemporary

banking and finance regulations governing Islamic finance have only been promulgated since the mid-1970s to mid-1980s in Islamic-majority countries, and just in the past decade in most other countries. This lack of a clear and certain body of both Islamic jurisprudence and secular law as it applies to Islamic finance raises considerable and unique legal risk exposures for Islamic finance institutions.

4. GREATER RISK FROM POOR DOCUMENTATION

Adding to the legal risks discussed earlier, further legal risk exposure arises in the context of legal documentation. Islamic finance currently does not enjoy the comfort of relying upon standardised document templates for even the most commonly occurring transactions. Instead, most Islamic finance transactions incur added risk exposure as a consequence of frequently "reinventing the wheel" when negotiating and drafting different sets of documents across different transactions or different aspects of the same transaction. This increases the likelihood that "ordinary" errors can occur, such as all-too-frequent slip-ups in drafting and execution resulting from cut-and-pasting of inapplicable contract provisions, inappropriate signatories indicated, or failure to properly sign, witness, and date documents. In addition, substantive errors that may occur in the context of conventional finance, such as failure to adequately anticipate events of default and to correlate remedies in the documents, create risk in Islamic finance, as well.

Distinct from conventional finance, moreover, Islamic finance documentation is further complicated by contractual formalities required for *Shari'ah* compliance and the consequent legal risk of *Shari'ah* non-compliance. Significant and unique legal risk exposure is created by *fiqh* rules governing capacity of the parties and, specific to the applicable *madhhab*, rules governing timing and other formalities in sequencing, execution, and witnessing of documents in a given transaction. Drafting Islamic finance documents also requires care be taken to avoid certain terminology which otherwise is common to conventional finance,[7] as well as requiring greater clarity and specificity in key contract terms to mitigate *gharar*. Moreover, there are *fiqh* limitations that must be considered in drafting contract terms providing an Islamic financial institution with remedies in the event a counterparty fails to render a payment or delivery as required by the contract, delineating claims in insolvency proceedings, and circumscribing *Shari'ah*-compliant restructuring of finance facilities. In addition, careful attention needs to be paid when drafting contract terms that require up-front payment of fees by the counterparty in a *murabahah* transaction[8]; when drafting *band al-jazza* penalty clauses in *istisna'a* contracts; drafting rebate

clauses in the event of early settlement by the counterparty[9]; and in drafting arbitration or other dispute resolution clauses in the contract.

Indeed, the very structuring of Islamic finance transactions is complicated by anticipation of legal risk exposure and attempts to incorporate corresponding risk mitigation techniques in the documentation. These include multiple-step or even parallel contracts in *murabahah* structures, as well as agency agreements appointing the finance institution or counterparty, respectively, as an agent for the other party in basic *murabahah* structures, as well as *tawarruq* and other commodity *murabahah* structures.[10] And in anticipation of a *Shari'ah*–non-compliance defense later by a counterparty in an attempt to avoid liability or enforcement of contract terms, Islamic financial institutions may seek to mitigate legal risk exposure by including in the transaction documentation a confirmation by the counterparty that it has independently made its own assessment that the transaction is fully *Shari'ah* compliant.[11]

5. GREATER RISK FROM UNPREDICTABLE DISPUTE RESOLUTION PROCESSES

The above-described legal risk exposures for Islamic financial institutions are often characterised as falling within the following categories: (a) "product risk," arising when a financial institution introduces a new product or changes an existing product; (b) "counterparty risk," such as when a counterparty lacks requisite capacity or authority to enter into a particular transaction; and, most commonly, (c) "transaction risk," arising from negotiations and drafting of documents that either fail to comply with legal/regulatory requirements, fail to accurately reflect the parties' intentions, contain unenforceable terms and conditions (including those that are *Shari'ah*–non-compliant), or simply contain drafting errors.

Islamic finance institutions also face a further significant category of legal risk, however, often characterised as "process risk." This risk category arises in the context of litigation or other legal processes to resolve legal disputes. Internally, it includes risk exposure that arises from insufficient record-keeping and other information processes within a financial institution. Externally, it arises from the legal processes that are utilised in resolving disputes, such as litigation, arbitration, and other formal and informal dispute resolution frameworks.

In the case of Islamic finance, dispute resolution especially presents unique risk concerns, as well as unique opportunities. All Islamic finance market participants, whether financial institutions or counterparties transacting with them, seek stability and reliability and avoid volatility and risk.

Essential to this is a reliable, predictable, just, fair system of dispute resolution, and preferably one that has clear authority and legitimacy in the context of Islam. Some Islamic scholars have gone so far as to suggest that any dispute resolution based upon reference to secular fora or secular law is in violation of the *Shari'ah*. Furthermore, a significant risk concern is that a secular forum will not enforce all the provisions of Islamic finance contracts, particularly provisions making reference to the *Shari'ah*, or that they will not render judicial determinations consistent with the letter, and especially the more nuanced spirit, of the *Shari'ah*.

Dispute resolution in the context of Islamic finance is distinguished from conventional finance by an overlay of *Shari'ah* and *fiqh* principles, requiring the intermediary[12] in the dispute to have a thorough knowledge of the *Shari'ah* and doctrines of the various *madhahib* governing a particular Islamic finance transaction. When confronted with complex Islamic finance products and structures, therefore, it is not sufficient that the courts simply understand basic concepts of conventional finance, their ostensibly analogous counterparts in Islamic finance, and the secular commercial law of the given jurisdiction. Indeed, even the fundamental principles of Islamic law may be quite elusive to conventional legal scholars and jurists lacking in-depth education and experience in the subject. Contemporary Islamic finance transactions significantly transcend a simple set of clearly defined rules based on what is *halal* and what is *haram*, and even in-house *Shari'ah* advisors charged with determining the permissibility of certain financial products and structures often find themselves in a quandary. The difficulty in fully understanding Islamic law and finance, and applying or incorporating the concepts, principles and rules correctly into transactions and documentation entered into by financial institutions, significantly increases the legal risk exposure for an Islamic finance institution.

In addition, parties to an Islamic finance transaction may also encounter difficulty in persuading a court to enforce fully the terms of the transaction, or to interpret them in full accordance with the *Shari'ah*, especially if there is conflict with the relevant and controlling law of the state. Including a clear choice of the *Shari'ah* as governing law in the transaction documents may still be wise from a practical perspective as well as in meeting the religious interests of the parties. Particularly in a secular (non-*Shari'ah*-incorporated) jurisdiction, however, secular courts may refuse to enforce a *Shari'ah* choice of law, on grounds of public policy or established private international law (conflict of laws) principles. As discussed above, private international law rules generally permit only one legal system to govern a contract, and then only the law of a country and not non-state or religious law. In the case of *Beximco Pharmaceuticals Ltd & Ors v Shamil Bank of Bahrain EC*,[13] for example, an English court refused to enforce the contract's governing law

provision asserting that the contract be "[s]ubject to the Glorious Sharia'a," instead deferring to the laws of England. Significantly, the *Beximco* court also noted "considerable controversy and difficulty" in translating traditional *fiqh* into propositions of modern law, as well as the "existence of a variety of schools of thought with which the court may have to concern itself" before a case applying the *Shari'ah* can be decided. As underscored by *Beximco*, in fact, before the parties are even able to address the merits of their respective positions in a legal dispute, the parties are also faced with the difficult task of assisting the court in understanding the complexities of the *Shari'ah*, applicable *fiqh*, and industry practices and standards applicable in a given Islamic finance transaction.

An important mitigant to the legal risk inherent in Islamic finance dispute resolution is the rapidly growing use of arbitration and other forms of alternative dispute resolution (ADR) in Islamic finance.[14] Bypassing especially the secular courts in favor of ADR provides desperately needed subject matter expertise in Islamic finance dispute resolution.[15] In addition, an ADR intermediary is generally not constrained by private international law principles, such as those discussed above in the context of *Beximco*, limiting the parties' ability to choose the *Shari'ah* as governing law in their transaction. Instead, an ADR intermediary should in most jurisdictions be free to decide disputes in accordance with any principles as the parties agree, including legal principles other than national law, such as the *Shari'ah*.[16] Moreover, particularly if there is a concern about the recognition of foreign judgments across borders, especially judgments based upon *Shari'ah* principles, arbitration is likely to afford the parties broad enforceability under the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards, to which 146 countries are currently signatories.[17]

In choosing an ADR forum and intermediary for Islamic finance disputes, a cautionary note should be expressed with respect to the ADR provision drafted by the parties, in order to ameliorate rather than exacerbate process risk exposure. It is common practice for most lawyers to simply include in Islamic finance documents a standard ADR clause, mirroring the clauses used in conventional transactions. These clauses usually provide for arbitration and/or mediation in accordance with applicable statutory law, if any, and further incorporate by reference a particular ADR institution's rules or other procedural framework. As the Islamic finance industry continues to grow and mature, and as rapidly increasing numbers of defaults have been arising in the context of Islamic finance, dispute resolution clauses and agreements need to be more of a forethought than an afterthought. Greater innovation in drafting ADR clauses is needed, carefully setting forth the agreed upon qualifications and expertise of the ADR intermediary, for example, as well as the particular *madhhab* and specific principles of

fiqh al-mu'amalat, and any industry standards promulgated by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), the Islamic Financial Services Board (IFSB), and other international standard setting bodies.[18]

6. CONCLUDING REMARKS

It is ironic that the very foundation that makes Islamic finance a potentially thriving industry—the *Shari'ah* and its role in suggesting antidotes to many of the underlying ills of conventional finance—is also the unique factor that increases legal risk exposure in modern Islamic finance as compared with conventional finance. While the industry demands that products and operations of Islamic financial institutions be fully *Shari'ah*-compliant, most jurisdictions' surrounding legal frameworks of laws, regulations, and courts generally do not support application of the *Shari'ah* in Islamic finance transaction and, in some cases, may be hostile toward the application of *Shari'ah*. Indeed, Islamic finance finds itself in a most peculiar and unique position of relying upon a body of finance law that is rigorously applied from inception to the conclusion of a given transaction in terms of concepts, principles, and rules (always under the watchful eyes of a *Shari'ah* Supervisory Board), yet it is seldom specified or enforced as the governing law for the construction, interpretation and dispute resolution regarding the given transaction and documentation.

Indeed, while the *Shari'ah* is the one necessary component in all aspects of Islamic finance, it becomes an unwelcome guest after the product has been structured and, in fact, becomes a potential liability from the perspective of legal risk exposure. It appears that much more legal risk exposure is incurred in an Islamic finance transaction, as the transaction and documentation surrounding it are carefully structured to comply with a particular body of law (the *Shari'ah*), but with the further reality that yet a different or additional (secular) law will govern the transaction instead. In short, instead of effectively mitigating the legal risks of the financial institution in relation to the transaction, the financial institution's legal risks have, on the contrary, increased.

It is suggested in this chapter that the solution to this ironic disconnect between the intentions of the Islamic finance industry to find a path which is less risky for all participants than conventional finance, and the reality of *Shari'ah* compliance actually causing more problems than it avoids, lies simply with much greater education and awareness of the basic principles of Islamic finance on the part of all the industry players. It is the lack of understanding and experience that results in faulty structuring of Islamic

finance transactions, the usage of inappropriate terminology, charging of rates or upfront fees that are not *Shari'ah*-compliant, or documentation that is actually inconsistent with the very Islamic concepts upon which the transaction is based.[19] While it may involve considerable time, effort and costs, which financial institutions, regulators and other industry players generally may not be willing yet to expend at this still-early stage of development, it is imperative that much more thought and effort be invested in knowledge development as the first step towards having the meaningful legal risk management process that is proving to be essential for Islamic finance.[20] With deeper knowledge and greater understanding of Islamic finance and the *Shari'ah* and *fiqh* principles upon which it is based, comes better and more innovative structuring, clearer and tighter documentation, more reliable dispute resolution, and a stronger framework of enabling laws and regulations needed for better legal risk mitigation and avoidance.

NOTES

1. Professor Andrew White is the Director of the International Islamic Law & Finance Centre and Associate Professor of Law, Singapore Management University. Mrs. Chen Mee King is Senior Vice President, Head of Legal and Corporate Secretariat, Legal and *Shari'ah* Group, The Islamic Bank of Asia Limited (Singapore & Bahrain); Mrs. Chen is also an Adjunct Associate Professor of Law, Singapore Management University. The views expressed in this chapter do not necessarily express the views of either the SMU or The Islamic Bank of Asia Limited.
2. While much of the contemporary authoritative literature (e.g., AAOIFI *Shari'ah* standards and IFSB standards) uses the terminology, "*Shari'ah* rules and principles" as a comprehensive concept that refers to both the *Shari'ah* and *fiqh*, subtle distinction between the two must be kept in mind. *Shari'ah* is a divinely ordained path; *fiqh* is the product of rational human endeavor (hence the various *madhahib* of slightly differentiated *fiqh*), practical rules derived through a combination of interpretation and *ijtihad* from detailed evidence in the sources of the *Shari'ah* (a process generally regulated by *usul al-fiqh*). And while the *Shari'ah* broadly governs the Islamic finance industry, it is *fiqh* that is criticised and debated in determining points of agreement, as well as disagreement across *madhahib*, as to the validity of structures and contract terms.
3. In the EU, for example, the Convention on the Law Applicable to Contractual Obligations 1980, known as the Rome Convention, mandates that contracts be governed by only the legal system of a country. This principle was emphasised in the context of Islamic finance in the English case of *Beximco Pharmaceuticals Ltd & Ors v Shamil Bank of Bahrain EC* [2004] EWCA Civ 19 (28 January 2004), in the Supreme Court of Judicature, Court of Appeal (Civil Division), on appeal from the High Court of Justice Queen's Bench Division (Morison J).

4. Indeed, a "pretty good way to generate an outcry, as the Archbishop of Canterbury learned in Britain recently, is to say that a Western legal system should make room for Shariah, or Islamic law." Adam Liptak, "When God and the Law Don't Square" *The New York Times* (17 February 2008), www.nytimes.com/2008/02/17/weekinreview/17liptak.html?pagewanted=print.
5. It should be noted that modern Islamic finance products generally are based upon nominate contract schemes and partnership principles that date back to (and even pre-date in some cases) the revelation of Islam, although their development as analogues to conventional finance facilities began in the 1970s and 1980s.
6. A recent project undertaken by students at the Singapore Management University, for example, identified fewer than two dozen reported Islamic finance cases across all common law jurisdictions, as at March 2012.
7. It is surprising that conventional finance terminology such as "repayment," "loan," "interest," "guaranteed rate of return," and indiscriminate use of "late payment penalty" clauses, may still be found in some Term Sheets and other Islamic finance documentation.
8. "Upfront Fees" and "Commitment Fees," which are usually paid upfront or for the commitment to provide a facility, would generally not be acceptable. Fees paid should be in respect of services performed or to be performed in relation to the transaction.
9. Rebate may be requested or may be given at the discretion of the recipient of the early settlement or payment amount, without any rate or formulae being specified or referenced.
10. Although such provisions are not sure or conclusive ways to handle the risks, it is not unusual to find included in the transaction documentation various provisions imposing upon the counterparty, as agent for the financial institution, an obligation to ensure that the assets purchased by it are as required by specifications; this may be helpful later to the financial institution if necessary to claim a defense or even a counterclaim against the counterparty, in the event the counterparty (as purchaser) brings a claim against the financial institution for breach of warranty.
11. This may help avoid precisely the problems encountered in *The Investment Dar Company KSCC v. Blom Developments Bank SAL* [2009] EWHC 3545 (Ch).
12. Typically, this is a secular trial judge, or—if an alternative form of dispute resolution is agreed upon by the parties—a designated arbitrator or a mediator, often acting administratively within the framework of a formal dispute-resolution institution.
13. See note 3, *supra*, *Beximco Pharmaceuticals Ltd & Ors v Shamil Bank of Bahrain EC* [2004] EWCA Civ 19 (28 January 2004), in the Supreme Court of Judicature, Court of Appeal (Civil Division), on appeal from the High Court of Justice Queen's Bench Division (Morison J).
14. In the context of Islamic finance dispute resolution, it has been suggested that the conventional term, ADR, be replaced with a more appropriate term, IDR, encompassing a form of Islamic dispute resolution that incorporates both

substantive and procedural approaches to dispute resolution inherent in Islamic legal tradition. This innovative concept is discussed at length in Andrew White, "Dispute Resolution and Specialized ADR for Islamic Finance," Chapter 12, *Islamic Finance: Law and Practice*, edited by Craig R. Nethercott and David M. Eisenberg (Oxford, UK: Oxford University Press, 2012).

15. At the same time, ADR for Islamic finance can also accommodate Islamic legal values and traditions, resurrecting the traditional Islamic concept of dispute settlement (*sulh*), and subsuming notions of non-binding mediation (*wasata*) and binding arbitration (*tahkim*) into a single ADR process. (Source: see note 14).
16. Not long after the decision in *Beximco*, the English High Court of Justice (Chancery Division) held that the *Shari'ah* may be applied to the subject matter and resolution of a dispute in arbitration, where the parties have so chosen in the contract itself. In *Musawi v RE International (UK) Ltd & Ors*, [2007] EWHC 2981 (Ch) (14 December 2007), the court held that although only English law could govern the interpretation of the agreement itself, resolution of the actual dispute between the parties was to be in accordance with the *Shari'ah*.
17. See www.newyorkconvention.org/new-york-convention-countries as of 26 February 2012.
18. This is discussed in greater detail, and a suggested IDR clause is provided, in Andrew White, "Dispute Resolution and Specialized ADR for Islamic Finance," *supra* note 14.
19. A good example is the use of clauses that effectively promise fixed returns in a transaction based on *wakala*, such as apparently occurred in the *TID v Blom* transaction, *supra* note 11.
20. Fortunately, the shortage of experts with education, training, and experience in the *Shari'ah*, applicable secular commercial law, and Islamic finance is currently being addressed in the interest of increasing overall "human capital" available to the Islamic finance industry. The absence of facilitative legal and institutional frameworks, however, remains largely unaddressed, even in countries with significant Muslim populations.

CHAPTER 11

Shari'ah–Non-compliance Risk

Mohamad Akram Laldin

1. INTRODUCTION

Risk is an inseparable element of life and business. Islamic financial institutions (IFIs), being commercial entities, face risk just as their conventional counterparts do, and they too must attempt to mitigate and avoid it. Being premised on *Shari'ah* principles does not at all mean that they are risk free. In fact, IFIs share many types of risk with their conventional counterparts, such as credit risk, market risk, and liquidity risk, and they are additionally exposed to certain risks that are unique to the nature of their business. This is due to the three following facts:

1. Islamic financial instruments are structured upon specific models and certain Islamic structures that distinguish them from their conventional instruments;
2. IFIs have a unique balance sheet as compared to their conventional counterparts; and
3. IFIs have their own specific regulations, governance framework, and liquidity infrastructure.[1]

One of the unique risks faced by IFIs is *Shari'ah*–non-compliance risk triggered by failure to adhere to *Shari'ah* principles. Understanding *Shari'ah*–non-compliance risk is very important, as it will provide the framework for dealing with and managing that risk. This chapter will deliberate *Shari'ah*–non-compliance risk in IFIs by providing an overview of the concept of risk from an Islamic perspective, the concept of *Shari'ah*–non-compliance risk and its measurement, the impact of *Shari'ah*–non-compliance risk, and how to rectify contracts that are not *Shari'ah* compliant.

Islamic Finance: The New Regulatory Challenge.
Edited by Simon Archer and Rifaat Ahmed Abdel Karim
Copyright © 2013 by John Wiley & Sons Singapore Pte. Ltd.
ISBN: 978-1-118-62897-3

2. RISK FROM AN ISLAMIC PERSPECTIVE

Islam is a comprehensive way of life governing every aspect of human life. The objectives of Islamic law, called *maqasid al-Shari'ah*, aim at securing public benefit and eliminating harm. It is a universal teaching that promotes simplicity and flexibility and avoids rigidity and complexity. As risk, in many circumstances, leads to harm, management of risk is encouraged, even commanded in Islam, through various processes and means. The famous Prophetic command to a Bedouin, "Tie your camel," serves as an essential foundation of risk management in Islam. In this *hadith*, a Bedouin asked Prophet Muhammad (peace be upon him), "Messenger of Allah, should I tie my camel and trust [in God] or leave it untied and trust [in God]?" The Prophet told him, "Tie your camel and put your trust in God."[2] The significance of the *hadith* is that the Prophet (pbuh) ordered people to exercise due diligence to reduce the unpleasant outcome in the future while placing trust in God.

Risk management is not a new concept in Islam. The historical facts show that risk management has been adhered to during the ancient ages. In the history of Prophet Yusuf (a.s), he was successfully overcoming the food crisis through appropriate risk mitigation means. The Qur'an recorded this event when it says that the King of Egypt dreamt that seven skinny cows devoured seven fat cows, and seven withered grain over seven green ears of corn.[3] Prophet Yusuf (a.s) interpreted the dream as the forthcoming of rainy season, proliferation of plants, and a bountiful harvest for seven years. But that season will be followed by a seven-year drought, dry season, and widespread famine.[4] The king then appointed Prophet Yusuf as minister of finance to manage the income and expenditure of state in order to stabilise the economic condition during fertile years and drought years.[5] He then built food storage warehouses and instructed people to avoid excessive consumption[6] until he could solve the crisis. In modern risk management context, what Prophet Yusuf practised is called risk awareness and risk mitigation.

In financial transaction, risk management is very essential from an Islamic perspective. This falls within the ambit of one of the highest objectives of *Shari'ah*, which is protection of wealth (*hifz al-mal*). Al-Suwailem, in this regard, insightfully states: "If we define risk as possibility of loss,[7] then it becomes clear from an Islamic perspective that risk as such is not desirable. Islamic principles clearly call for the preservation and development of wealth. Exposing wealth to loss cannot be a goal in itself."[8] In fact, the Prophetic ruling that states, "Do not sell what you do not own,"[9] provides an indicator of risk prevention in the financial transaction because sale of an asset that a seller does not possess involves uncertainty and creates the risk that the asset will be undeliverable.

The issue of risk management has also been identified and widely discussed in *fiqh* literature. For instance, Imam Malik, the founder of the Maliki school of law, illustrated an example of risk in contract by saying: "In our opinion, buying a fetus in the womb is a type of risk and uncertainty because it is unknown whether or not it will be born; and if it is born, it is still unknown whether it will be good or bad, complete or deficient, or male or female. All of these variations will affect the price."[10]

Ibn al-Qayyim listed two types of risks from an Islamic perspective: trading risk and gambling. Trading risk may occur when a person purchases a commodity from a market; he then sells the commodity and gains a profit; gambling, however, is a method of acquiring profit by unlawful (i.e., prohibited) means that includes consuming wealth illegally and conducting illegitimate sale contracts such as *bay' al-mulamasah* (a touch sale) and *bay' al-munabadhah*[11] (a toss sale).[12] While the trading risk is permitted by the *Shari'ah*, gambling is prohibited as it involves injustice and unfairness.

Ibn al-Qayyim's categorisation has been further developed by Hassan (2009), who divided risk from an Islamic perspective into three types: essential, prohibited, and manageable risk.[13] Essential risk is the risk inherent to all profit-making activity. It must be borne in order to earn revenue or profit. Scholars developed the legal maxims *al-kharaj bi al-daman* (profit goes with liability) and *al-ghurm bil ghunm* (liability goes with profit) to indicate that risk goes hand-in-hand with profit. The higher the risk, the higher the profit that can be expected. In a sale contract, for example, a buyer who has the right of option (*khiyar*) to return an asset purchased is entitled to utilise it before it is returned to the seller. It is justified because the buyer bears liability to indemnify the asset in case of damage or loss.[14] Conversely, since the option reduces the buyer's risk, some jurists hold the view that it has an effect upon the price (i.e., the buyer pays more when reserving the option to annul than he would in a sale without that option).[15]

The second type of risk is prohibited risk, which refers to *gharar*. Generally, *gharar* takes place when there is considerable ambiguity related to either the term of the contract, or its object, or the counter-value. This type of risk is prohibited by Islam as it will lead to injustice, create harm to one of the contracting parties, and almost inevitably lead to disputes.

The third type of risk, permissible risk, is that which does not fall in either of the aforementioned categories.[16] The *Shari'ah* legitimises the management of this kind of risk and allows people to determine the method for dealing with it, as long as it does not involve a clearly prohibited means. The Prophet (pbuh) said, "You know better (than me) about your worldly affairs."[17] Examples of this kind of risk include, among others, operational risk, liquidity risk, credit risk, market risk.

In Islam, there are two methods of dealing with risk, namely, risk sharing and risk transfer. While risk transfer, or risk shifting, is an inseparable characteristic of conventional institutions, risk sharing is more consistent with the spirit of the *Shari'ah* and thus more appropriate for Islamic finance in developing its products. Many conceptual models and structures of Islamic contracts are based on the profit-sharing approach; for example, *mudarabah, musharakah, muzara'ah*, and *musaqah*. Conceptually, risk sharing is more just since it will create a more equitable distribution of income and wealth between the wealth owner and the entrepreneur, while risk transfer causes a transfer of wealth from the entrepreneur to the wealth owner that is independent of the outcome. In terms of efficiency, risk sharing is more efficient for two main reasons. First, in making the allocation of investible funds, the investor in its "due diligence" evaluates the feasibility and viability of the project, while in interest-based risk transfers funds are predominantly allocated based upon the recipient's credit rating rather than the viability of the project as such. Second, for related reasons risk sharing encourages entrepreneurship and innovations while risk transfer constitutes a guarantee of the capital and a positive return to the creditor, provided the debtor is solvent, and thus encourages a passive attitude on the part of the financier.[18,19]

3. THE CONCEPT OF *SHARI'AH* COMPLIANCE

The protection of wealth is one of the noble *Shari'ah* objectives. In the hierarchy of *maqasid al-Shari'ah*, it is classified at the highest grade of *maslahah* (benefit), being one of the essentials (*daruriyyat*). Hence, Islam has provided detailed and comprehensive guidelines and rules regarding the acquisition of wealth. Wealth acquired by means that violate these rules is considered illicit and is tantamount to spiritual poison. Therefore, it is essential that any business activity be *Shari'ah* compliant.

The word "*Shari'ah*" literally means a road to a source of water or a straight path to be followed. As a technical term, *Shari'ah* was defined by al-Qurtubi as the canon of Islamic law, all the different commandments of Allah to mankind.[20] Thus, "*Shari'ah* compliant" can be broadly defined as an activity that is in accordance with the law of Islam. An IFI can be described as *Shari'ah* compliant if it provides products and services in line with *Shari'ah* rules and principles, while a product can be called *Shari'ah* compliant if it fulfils the technical requirements of the contract upon which it is based.

The broad dimensions of *Shari'ah* compliance in finance can be extracted from a *hadith* of Prophet Muhammad (pbuh) in which he laid

down two dimensions that need to be observed in wealth-generating activities: (1) *min aina iktasabahu* (how the income is acquired) and (2) *fima anfaqahu* (where the income is spent).[21] The *hadith* points out that wealth should be earned and spent through *halal* and wholesome means. It also signifies that Islam requires beginning-to-end *Shari'ah* compliance, including the process, the implementation, and the output, from production to distribution to consumption. In the Islamic banking field, *Shari'ah* compliance must be observed both in the bank's acquisition of funds and its financing activities.

From a more specific perspective, *Shari'ah* compliance in products and services is commonly associated with Islamic contracts. Islamic contracts are the basis of transactions in financial activity. They are introduced to create mutual consent among parties involved and eliminate prohibited elements in financial transactions. Compliance with the *Shari'ah* in this context is achieved if a product or service is constructed on the basis of a legitimate and valid contract. The Islamic law provides various types of legitimated contracts that might be applied in formulating products and services; for example, partnership-based contracts (*mudarabah* and *musharakah*), sale-based contracts (*murabahah*), and lease-based contracts (*ijarah*). The validity of a contract is achieved if the required pillars and conditions of the contract are fully satisfied and it is free of any prohibited elements. Generally, there are three pillars to be satisfied for the validity of any contract: the contracting parties; the subject matter (asset and counter-value); and offer and acceptance. For each pillar there are several conditions to be fulfilled. Failure to satisfy any pillar of a contract or any of its conditions will render the contract invalid. The result is *Shari'ah* non-compliance.

The conditions of each pillar may vary from one contract to other because each contract has its own specific features, requirements, and implications. In a *murabahah* contract, for example, a seller is required to disclose the acquiring price and the margin (mark-up) of profit for the goods. However, this is not required in a *salam* contract; at the time of contracting, the buyer typically does not know at what price the commodity will be sold after delivery. Likewise, while the seller must possess the asset to be sold in a *murabahah* contract, there is no such requirement in an *istisna'a* contract, where *gharar* is mitigated by a detailed specification of the asset to be delivered, and so on. Having said that, it is important to observe that, generally, the contracting parties in any contract must be legally eligible to execute the contract, meaning that they must be sane, of the age of majority (which in Islamic law is puberty), and not be interdicted (*mahjur*).[22] The subject matter (*ma'qud 'alaih*) should be an asset recognised as wealth by the *Shari'ah*. That means it cannot be a prohibited substance, and it must, moreover, be something that people are willing to exchange wealth for in

order to possess. Other conditions of the subject matter are that it must be free from uncertainty and ambiguity (*gharar*), known by both parties, and in existence at the time of the contract.[23] Offer and acceptance must be clear and understandable; what is being accepted must be consistent with what is being offered; and traditionally, the acceptance should follow the offer without delay.[24] In modern commerce, jurists allow offer and acceptance to occur over a distance by fax, email, and the like. In such cases, there will inevitably be some time delay, in which case, the length of an acceptable delay would have to be determined on the basis of custom (standard commercial practice). In addition, the validity of a contract requires that it be free from prohibited elements such as interest (*riba*), duress (*ikrah*), mistakes (*ghalat*), gross overcharging (*ghubn*), and deception (*taghrir*).

However, according to Saiful Azhar Rosly, the *Shari'ah* compliance of a product cannot be determined simply by considering the technical requirements of contract. He laid down four parameters to measure whether or not a particular product or service is in compliance with *Shari'ah* principles.[25]

The first parameter is the '*aqd* approach. '*Aqd* (contract) is the foundation of transactions in Islam. Islam emphasises that transactions between two parties have to be established on the basis of mutual consent,[26] which is translated into modern practice through the law of contract. The three contract pillars mentioned above are the means by which mutual consent is realised. A product is deemed *Shari'ah* compliant from this perspective provided it has fulfilled all of the essential pillars and conditions of the contract.

The second parameter is the *maqasid al-Shari'ah* approach. Assessing the *Shari'ah* compliance of a product by its fulfilment of the contract requirements is not sufficient. It has to be consistent with the achievement of the noble objectives of the *Shari'ah*, which are, in general, securing benefit and justice and repelling injury and harm. The objectives of the *Shari'ah* are achieved when at least five basic necessities are well preserved: religion, life, wealth, intellect, and dignity. In the financial context, products and services achieve the *maqasid al-Shari'ah* when they contribute to the stability of the economic and financial sector, create social distributive justice, secure the basic needs of society, and put emphasis on ethical investment.

The third parameter is the financial reporting approach. This parameter must also be taken into account in determining *Shari'ah* compliance of IFIs, as it serves to eliminate uncertainty (*gharar*) and shortchanging (*tatfeef*) in financial contracts through accurate transactional reporting. More importantly, financial reporting precisely explains the form of the contract conducted, whether it is a loan or sale, and whether a sale is a true sale or not.

The last parameter is legal documentation. While the '*aqd* approach primarily serves to provide general principles, the legal documentation of a contract is an expression of that contract that aims to provide security and

protection to the parties involved. The documentation will help parties to know their rights and assume their responsibilities. It also enables them to seek legal protection in case the outcome of the contract is not satisfied as agreed.

In modern financial institutions, the concept and parameters of *Shari'ah* compliance are institutionalised in the form of resolutions, *fatawa*, standards, and guidelines. The *Shari'ah* boards of IFIs are assigned to ascertain that their business activities, particularly in their products and services, are end-to-end *Shari'ah* compliant. To do so, they should refer to the resolutions, rulings, and guidelines of the relevant bodies in their respective jurisdictions. They play a central reference and front-end role in determining the *Shari'ah* compliance status of financial instruments based on contract (*'aqd*) requirements. The general duty of the *Shari'ah* board, as defined in the standards of the *Shari'ah* board of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), is "directing, reviewing and supervising the activities of the Islamic financial institution to ensure that they are in compliance with *Shari'ah* rules and principles.[27]

To assist the *Shari'ah* board in performing the review for *Shari'ah* compliance, AAOIFI has published Governance Standard for Islamic Financial Institutions (GSIFI) No. 2 on *Shari'ah* review. *Shari'ah* review is undertaken by the *Shari'ah* board to examine whether the activities carried out by an IFI are in accordance with the applicable *Shari'ah* principles and rules. The examination includes contracts, agreements, policies, products, transactions, memoranda and articles of association, financial statements, reports (especially those on internal audits and central bank inspections), circulars, and so forth.[28]

Based on GSIFI No. 2, there are three stages to be followed in carrying out a *Shari'ah* compliance review: (i) planning review procedures; (ii) executing review procedures; and (iii) documenting conclusions and report. The explanation of the three stages follows.[29]

3.1 Planning Stage

According to the standard, the *Shari'ah* review process should be properly planned and adequately developed to include a comprehensive understanding of the IFI's A-to-Z operation in terms of products, size of operation, locations, branches, subsidiaries, and divisions. It has to cover a list of *fatawa*, resolutions, and guidelines issued by the *Shari'ah* board. Moreover, the management's understanding of all the activities and products and its awareness of and attitude toward *Shari'ah* compliance are also important matters for consideration as they will directly affect the nature, extent and timing of the *Shari'ah* review procedures.

To ensure the comprehensiveness of the review procedure, it should cover all activities, products, and locations. These procedures should ascertain whether the transactions and products approved by the *Shari'ah* board have been properly undertaken and whether all related conditions have been met.

3.2 Execution Stage

At this stage, all the aforementioned planned review procedures are executed. Normally, the *Shari'ah* board's review procedures will include the following processes:

- Understanding management's awareness, commitment, and compliance control procedures for adherence to the *Shari'ah*.
- Reviewing contracts, agreements, and the like.
- Ascertaining whether transactions practiced during the year were with products authorised by the *Shari'ah* board.
- Reviewing other information and reports such as circulars, minutes, operating and financial reports, policies and procedures, and so on.
- Consultation/coordination with advisors such as external auditors.
- Discussing findings with the IFI management.

3.3 Documentation Stage

After review procedures are executed, the *Shari'ah* supervisory board (SSB) should put the conclusion into documentation and prepare a report to the shareholders based on the work undertaken. The SSB report should be read at the annual general meeting of the IFI. The detailed report, when warranted, should also be issued to the IFI's management.

The *Shari'ah* review performed by the *Shari'ah* board and the internal *Shari'ah* review are not sufficient to assure that all activities are in compliance. They should be re-examined. Therefore, AAOIFI established Auditing Standard for IFIs No. 4 to test whether activities reviewed by the *Shari'ah* board are compliant with *Shari'ah* rules and principles. The scope of an external audit may include attesting to whether the IFI's transactions are in compliance with *fatawa* and guidelines issued by the *Shari'ah* board. Alternatively, this function may be fulfilled by an internal *Shari'ah* review carried out by specialised internal audit staff of the IFI. The aim is to ensure that the IFI, when introducing a new product or modifying an existing product, is following procedures that are in compliance with *Shari'ah* principles; to assure that all new *fatawa* and guidelines have been reviewed; to review available documents to make sure that all types of products offered

by the IFI have been reviewed by the SSB in accordance with GSIFI No. 2; and to verify that the transactions undertaken by the IFI are consistent with the *fatawa* and guidelines issued by the *Shari'ah* board.[30]

The Islamic Financial Services Board (IFSB) has issued IFSB-10 *Guiding Principles on* Shari'ah *Governance Systems for Institutions Offering Islamic Financial Services*[31] (December 2009). This standard delineates a system of internal control of *Shari'ah* compliance, comprising a continuous internal audit process and an annual review. The principal aim of this system is to minimise *Shari'ah*–non-compliance risk, as described in the next section.

4. *SHARI'AH*–NON-COMPLIANCE RISK AND ITS IMPACT

Shari'ah–non-compliance risk is a significant portion of the risk to which IFIs are exposed. In the hierarchy of risk, *Shari'ah* compliance risk is considered a dimension of operational risk. While operational risk is a risk that arises from failures in internal control involving processes, people, and system, *Shari'ah*-compliance risk as defined by IFSB is a term used to describe the risk arising from an IFI's failure to comply with the *Shari'ah* rules and principles determined by the *Shari'ah* board of the IFI or the relevant body in the jurisdiction in which the IFI operates.[32]

Shari'ah–non-compliance risk is deemed as a higher priority category of risk for IFIs than other identified risks. This is based upon two reasons: first, the majority of IFIs' fund providers perceive *Shari'ah*-compliant services to be a matter of principle, so their perceptions regarding an IFI's compliance with *Shari'ah* rules and principles are very important for their sustainability; second, contravention of *Shari'ah* rules and principles could lead to a transaction being nullified, which would render the income generated from them to be deemed impermissible.[33]

The IFSB's *Guiding Principles of Risk Management* point out that IFIs should have adequate systems and controls, including a *Shari'ah* board/advisor, to ensure that they comply at all time with *Shari'ah* principles. The guideline also emphasises that contract documentation be in compliance with *Shari'ah* rules and principles (i.e., with regard to enactment, termination, and elements that could possibly affect the validity of the contract such as fraud, misrepresentation, duress, or any other infringements upon rights and obligations). In addition, to ensure *Shari'ah* compliance and avoid *Shari'ah* risk, the guideline also advises IFIs to undertake a *Shari'ah* compliance review at least annually. In addition, the standard also stresses that IFIs cannot recognise the income arising from *Shari'ah*–non-compliant elements.[34] As noted above, the IFSB has since issued IFSB-10, a set of guiding

principles specifically concerned with the management of *Shari'ah*–non-compliance risk.

Shari'ah non-compliance may have legal consequences that would also affect the operation, financial position, and reputation of an IFI. A court decision unfavourable to an IFI's position, such as deciding that the underlying contract employed by an IFI in a particular product is invalid, might have negative effects for the IFI such as financial loss and reputational loss.

In addition, IFIs might suffer financial loss as a result of (i) compensation or damages to be paid to customers; (ii) donating to charity any profit generated from the facility, while the client repays only the principal amount (so that the IFI has to write off any earned profit and suffer the opportunity cost of the principal amount); (iii) possibly, bearing the cost of lawsuits or of court proceedings.[35] Non-compliance with the *Shari'ah* might also pose reputational risk for an IFI, causing the public as well as the shareholders to lose confidence in its integrity and credibility. The decline of an IFI's reputation for *Shari'ah* compliance might result in loss of revenue, as customers might withdraw their funds, and hence diminish the profitability of the IFI and reduce shareholder's value. Eventually, this reputational loss could trigger a migration of investors' funds from the IFI to other financial institutions, perhaps even to conventional financial institutions.

5. DEALING WITH *SHARI'AH*–NON-COMPLIANCE RISK

Shari'ah compliance, as discussed in the previous section, is very broad in scope, covering every operational angle of an IFI's activities. An IFI's failure to comply with the *Shari'ah* in its operations will expose it to *Shari'ah*–non-compliance risk. However, in most cases, the occurrence of *Shari'ah*–non-compliance risk is usually linked to IFI products when a court rules that the underlying contract employed is invalid due to the inconsistency between the *Shari'ah* requirement and the legal documentation. Therefore, in this respect, two aspects of an IFI's practices should be carefully examined, namely the concept of the contract and legal documentation. The former deals with the nature and principles of a transaction; the fulfilment of its pillars and conditions is essential in determining its validity. The latter is the translation of contract principles and requirements into practice, providing details about the rights and obligations of the contracting parties. In practice, *Shari'ah*–non-compliance risk commonly results from defects in legal documentation because it is the main reference and evidence in relation to the transaction, particularly in the event of default. Therefore, proper legal documentation is crucial in order to ensure that the rights and obligations of all involved parties are properly defined and that *Shari'ah* guidelines are followed.

There are two categories of defect that may lead to *Shari'ah*–non-compliance, namely critical defect and reparable defect.

5.1 Critical Defect

This is a type of defect in a contract arising from violation of the contract's pillars and conditions. In jurisprudential terminology, violation of a pillar will render the entire contract void (*batil*). This type of defect cannot be rectified and a fresh contract needs to be drawn up. There are many cases where this applies to a financial product and leads to nullification of the contract, which exemplifies *Shari'ah*–non-compliance and its consequences. The violation of a pillar in a particular product may be in the product's structure or in its terms and conditions.

For example, in a *murabahah* home financing contract, a critical defect could be due to the nonexistence of the subject matter when the contract is concluded, or to the IFI's sale of an asset that is not in its possession, or the lack of a real transfer of ownership. It is also deemed a violation of the pillars in the legal documentation of a *murabahah*-based product if the sequences of the contract are not properly observed, such as a property sale agreement in a *murabahah* contract that is concluded before the property purchase agreement. Likewise, excessive uncertainty, such as ambiguity of price (e.g., the contract contains two prices, or an unknown delivery date that leads to dispute and the invalidation of the contract), is deemed a violation of the pillars.

In addition, a product is considered to violate a pillar when the underlying business activity contains a prohibited element such as interest-based investment activities, gambling-based activities or other non-*halal* activities. The best example is investment activities in securities or shares. In the case of Malaysia, under the guideline of the Securities Commission, the listed shares of a company are considered *Shari'ah*–non-compliant if the noncompliant proportion of its underlying assets or activities exceeds a certain benchmark. The benchmarks established are (1) 5 percent for activities that are clearly prohibited, such as *riba* (interest-based companies like conventional banks), gambling, and production or sale of liquor or pork; (2) 10 percent for activities that involve the element of '*umum balwa* (a prohibited element affecting most people and difficult to avoid), such as interest income from fixed deposits placed in conventional banks or tobacco-related activities, and (3) 25 percent for activities that are generally permissible according to *Shari'ah* and have an element of *maslahah* (public interest), although there may be other elements that could affect the *Shari'ah* status of these activities. Among these activities are hotel and resort operations, share trading, and stockbroking, as these activities may also involve other related activities that are impermissible in the *Shari'ah*.

5.2 Remediable Defect

This type of defect has a lower impact than the previous type because the defect is not as serious as the first. In this type of contract, the contract has basically satisfied the requirements and pillars, but it contains an external impermissible element in its accessory attributes that may lead to dispute. This is usually caused by human error in drafting the contract. In jurisprudential terminology, it is known as a defective contract (*fasid*).

There are many examples of this class of defect, such as an error in typing the day, month, or year of the contract in legal documentation, inappropriate use of terms such as interest, purchase undertaking, and so on. These kinds of errors are sometimes unavoidable, being due to weaknesses that are a part of human nature and also because of people's mindsets that have become used to dealing with conventional terms in their daily transactions over a long period of time. Another type of reparable error that may lead to *Shari'ah*–non-compliance is a lack of relevant information, such as failure to describe adequately the usufruct in a forward *ijarah* contract, or a defect due to an invalid condition. An example would be the existence of a purchase undertaking in a *musharakah sukuk* structure in which the originator guarantees at the time of contract to buy back the *sukuk* at par value instead of market value, which would contravene the *Shari'ah* requirements of the *musharakah* contract.

In addition, another example of possible source of *Shari'ah*–non-compliance within this category is when the terms governing late payment charges in sale-based financing exceed the actual cost incurred in following up with the client to receive the late payment, or if the Islamic bank treats the charge as income rather than channelling it to charity. Another potential source of *Shari'ah*–non-compliance risk is a combination of two or three contracts in one product using a master agreement facility without proper separation of the contracts, such as *bay' al-'inah* or *bay' al-murabahah*.

There are a number of court cases involving *Shari'ah*–non-compliance risk in the industry caused by defect in legal documentation that is inconsistent with *Shari'ah* requirements. In 2008, East Cameron Gas Co. ("East Cameron") declared its bankruptcy after its offshore Louisiana oil and gas wells failed to yield the expected returns due to hurricane damage. The issue in this case was whether or not the *sukuk* holders actually owned a portion of the company, as they should have done from a *Shari'ah* perspective. East Cameron claimed that there was no real transfer of ownership as reflected in legal documentation. Instead, the company claimed the transaction was merely a loan, implying that *sukuk* holders would have to share the royalties with other creditors in the event of liquidation. On the contrary, the U.S. Bankruptcy Court in western Louisiana ruled that the sale was a true sale, so

that the underlying assets used for the *sukuk* could not be included in the bankruptcy estate.[36] Strictly speaking, the East Cameron case is an example of legal risk where the intent and substance of a *Shari'ah*-compliant contractual arrangement may not be supported in the applicable secular law jurisdiction. In such a case, the failure to comply with *Shari'ah* results from this lack of support, and not from a defect in the *Shari'ah*-compliant contractual arrangement itself. Fortunately, in the East Cameron case, the decision of the court largely upheld that arrangement. But matters might have turned out differently, and the case is a good example of a certain source of *Shari'ah*–non-compliance risk

In 2009, the Investment Dar (TID), a Kuwaiti investment company, was reported that it was unable to make payment on a *sukuk musharakah* amounting to US$100 million that was set to mature in 2010. The English court ruled that TID had made an "arguable case" that the *wakalah* agreement—effectively a type of loan for US$10 million (Dh36.72 million) it had entered into with the Lebanon-based Blom Bank—was not in line with *Shari'ah* law. As a result, TID was required to repay only the principal, but not the profit, the court agreeing that the "profit" was effectively interest.[37]

In Malaysia, various cases have arisen as a result of a judge's invalidation of the BBA contract. The 2008 case *Arab Malaysia Finance Bhd v Taman Ihsan Jaya* and 12 other unsettled cases have had a negative impact on public perceptions of the *Shari'ah* compliance of Islamic finance. In these cases, Judge Abdul Wahab Patail ruled that the BBA contracts were not *Shari'ah* compliant because the contracts were contrary to the Islamic Banking Act 1983 (IBA) with a note that the BBA sale was "not a bona fide sale." As the BBA contract was ruled null, the defendant was required to return only the original amount of the BBA facility to the bank, thus eliminating the bank's profit on the transaction.[38]

6. MEASURING *SHARI'AH*–NON-COMPLIANCE RISK

Section 5 discussed when and where *Shari'ah*–non-compliance risk may occur and the types of defect that may trigger such risk. As defects are classified as either critical or remediable, this section will further deliberate the principle of void and defective contracts from an Islamic jurisprudence angle. It is important to examine this concept in order to be able to easily measure the level of *Shari'ah*–non-compliance risk resulting from contract invalidity.

With respect to validity, the majority of jurists agree that contracts can be divided into two possible statuses: valid (*sahih*) and invalid (*ghayr sahih*). A valid contract is one in which all the essential elements (i.e., contracting parties, subject matter, offer, and acceptance) and their conditions are

satisfied[39] and which is also free from prohibited elements such as *riba* and *gharar*. For example, a sale contract is deemed valid (*Shari'ah* compliant) when the parties have legal eligibility to execute the contract; offer and acceptance are clear and match one another; and the asset is valuable, existent at the time of the contract, free from uncertainty, and fully owned by the seller. A valid contract assigns all its effects that the *Shari'ah* has determined for it.[40] In contrast, an invalid contract (*ghayr sahih*) is one in which there is one or more violation of the pillars and conditions of the contract, such as selling blood, pork, and other prohibited commodities.[41]

The Hanafi school of law classifies *ghayr sahih* into two different types: void (*batil*) and defective (*fasid*).[42] There are substantial differences in meaning and implication between void and defective, according to Hanafi jurists. *Batil* (void) is a contract that has failed to fulfil a specific pillar or condition. Examples of *batil* contracts are those executed by parties without legal eligibility; or in which the offer and acceptance are not clear; or that violate one or more conditions of the subject matter (e.g., selling something which has no value from a *Shari'ah* perspective, such as pork, alcohol, fish in the river,[43] or birds in the sky); or selling public property (e.g., a road, hospital, or mosque). From an Islamic jurisprudence perspective, a void contract does not have any legal effect (i.e., the buyer does not acquire ownership of the subject matter while the seller does not have any right to the counter-value).[44]

The second type is a defective (*fasid*) contract. In this type, all the requirements and pillars are satisfied, but the contract contains one or more prohibited elements in its accessory circumstances or external attributes, such as selling an unidentified asset that will lead to dispute.[45] In this type, the contract is not irretrievably void (*batil*); rather, it is defective but reparable (*fasid*); if the objectionable elements are rectified or removed, the contract becomes valid.[46]

Hanafi jurists have identified the following three elements as leading to a defective contract:[47]

1. Lack of information regarding the subject matter of the contract, such as selling a property with the asset or price unidentified.
2. Two sales in one sale, also known as a contingent contract; for example, a party says to another, "I will sell you my house if you sell me a house."
3. A sale contract with an unlawful countervalue (i.e., the consideration for the asset is not allowed by the *Shari'ah*, such as pork, wine, etc.).

In conclusion, the level of *Shari'ah*–non-compliance risk can be measured through the Hanafi categorisation of invalid contracts (*ghayr shahih*): *batil* and *fasid*. A *batil* contract has greater impact on *Shari'ah*–non-compliance

risk, as it cannot be rectified and makes the contract void. *Fasid*, on the other hand, may be repaired by removing the objectionable elements.

7. *FIQH AL-MUWAZANAH*

Measuring *Shari'ah* compliance is not only done by looking into the technical requirements of contract validity; jurists also employ another tool, weighing benefit and harm, known as *fiqh al-muwazanah*. This concept is introduced because Islam is a religion having the objectives (*maqasid*) of realising benefit and avoiding evil. In general, any harm should be removed, and any benefit should be secured. However, there are some circumstances in which benefit and harm coexist. The question then arises as to which option should be given priority: securing benefit or avoiding harm? In this situation, it becomes important to assign each of them its proper weight.

The concept of *fiqh al-muwazanah* has been discussed by many jurists in the past. Ibn Taymiyyah, for example, stated: "The *Shari'ah* was revealed to secure *maslahah* and to prevent or reduce evil as much as possible. Its objective is to produce the best possible scenarios from two choices if both cannot be secured together, and to eliminate the worst of two harms if both harms cannot be prevented together."[48]

This idea has been comprehensively developed by a renowned modern scholar, Yusuf al-Qaradawi, in his notable works on the Islamic revival movement and the issue of Islamic resurgence. According to al-Qaradawi, *fiqh al-muwazanah* places primary emphasis on three areas: (1) balancing benefits against each other, in term of magnitude, value, effect, and persistence, so as to determine which should be given priority and which should be ignored; (2) balancing one harm against another to determine which one should be eliminated and which has to be accepted; (3) balancing between benefit and harm if they clash to determine which one should be given preference (i.e., avoiding harm or securing benefit).[49]

Benefit and harm should be prudently assessed and scrutinised in these scenarios with regard to their urgency, effect, magnitude and duration. They should, moreover, be examined according to their degree and level of priority. The following three parameters of *fiqh al-muwazanah* may serve as guidelines to provide rules of thumb for examining conflicts between benefit and harm:

1. If one benefit clashes with another benefit, the preference should be determine based on the hierarchy of *maslahah*. There are three levels of *maslahah*: necessity (*daruriyyah*), need (*hajiyyah*), and embellishment (*tahsiniyah*). The level of necessity (*daruriyah*) is indispensable in

human life; hence, it must be absolutely secured. It consists of preservation of five basic necessities: religion, life, mind, wealth, and dignity. The level of *hajiyyah* will lead to hardship if it is not achieved, while the level of *tahsiniyah* is associated with the perfection of ethics and the enhancement of life. From a *maqasidic* point of view, preference is to be given to the higher level. If a necessity clashes with a need, the necessity is given priority. Likewise, if a need conflicts with an embellishment, preference will be given to the need.[50]

2. If a harm is in conflict with another, the greater harm will be given priority. In other words, the greater harm should be avoided by bearing the lesser harm. It is in line with the legal maxim that states "In the presence of two evils, the one whose injury is greater is avoided by the commission of the lesser";[51] the maxim "Severe harm is removed by lesser harm";[52] and the maxim "The lesser of two evils is preferred."[53] Likewise, if one of two harms entails a private harm and the other public harm, the elimination of public harm is preferred, as the maxim says: "A private injury is tolerated in order to ward off a public injury."[54]
3. If benefit conflicts with harm, there are two possible scenarios. If the benefit is greater than the harm, securing the benefit will be preferred. In contrast, if the benefit is less than or on the same level as the harm, preventing harm is preferred.[55] It is supported by the legal maxim: "Repelling harm is preferable to securing benefit."[56]

Based on foregoing parameters of *fiqh al-muwazanah*, in many cases, when necessity conflicts with a prohibitive ruling, the necessity takes precedence. In other words, that which is prohibited by the prohibitive ruling becomes permissible. This principle is encapsulated in the maxim: "Necessity renders prohibited things permissible."[57] However, this should be applied within strict conditions. These seven conditions are:[58]

1. The harm must be actual and not expected. This means that the loss of property or the harm to people really exists.
2. The necessity must be real and not presumed. It means that the harm being faced is severe, involving the loss of life or limb, sanity, wealth, or disruption of the religion. In other word, the situation will spoil the achievement of one of the higher objectives of the *Shari'ah* of protecting the religion, life, intellect, dignity, and wealth.
3. There is no means of avoiding the harm except the prohibited action.
4. The prohibited action that is allowed based on necessity should be estimated accordingly so that it is only used to the extent necessary to remove the harm.

5. In the context of public necessity, the government should be sure of the occurrence of real necessity; for instance, great turmoil or serious harm will afflict the society if the prohibited action is not undertaken.
6. A person who falls in the situation of necessity should adhere to the general principles of *Shari'ah* such as upholding justice, protecting the rights of human beings and preserving the fundamental principles of religion (*usul al-din*).
7. The period of permissibility due to necessity (*darurah*) depends on its continued existence. If the *darurah* disappears, the period of permissibility also ceases. This principle is encapsulated by the maxim that reads: "Whatever is permissible owing to an excuse ceases to be permissible when the excuse disappears."[59]

There are many examples in Islamic finance of applications of the concept of weighing benefit and harm in evaluating the *Shari'ah* compliance of a product. In fact, many *fatawa* and resolutions are established by virtue of *fiqh al-muwazanah*. In some instances, it is found that the original *Shari'ah* ruling for a particular activity is that it is not legitimate, but scholars approve it on the basis of strong necessity or securing a higher *maslahah*. For example, in the case of the *takaful* industry, a *takaful* operator is not allowed to distribute or share its risk with conventional insurance or reinsurance. However, since there are not enough entities providing *retakaful* services to cover the risk of *takaful* companies, SAC BNM Malaysia, in its forty-seventh meeting, 14 February 2005, decided that it is permissible for a *takaful* company to distribute its risk through a conventional insurance or reinsurance company. However, it should be within three basic parameters:[60]

1. Priority should be given to a *takaful* company or *retakaful* company.
2. There should be no *takaful* company or *retakaful* company, either locally or internationally, that is considered capable of absorbing the distributed risks.
3. There is a *takaful* company or *retakaful* company, either locally or internationally, but it is of doubtful strength.

Another example of the application of *fiqh al-muwazanah* in Islamic finance is the establishment of benchmarks for determining the *Shari'ah* compliance of shares. The basic rule is that a share will only be considered *Shari'ah* compliant when all the underlying activities are in accordance with *Shari'ah* principles. However, it is virtually impossible to find a 100 percent pure *Shari'ah*-compliant share. At the same time, there is a real economic need for having shares as one domain in which money can be invested.

Based upon that, the SAC of the Securities Commission weighed benefit and harm and established tolerable levels for noncompliant activities. If the noncompliant element, as discussed earlier, exceeds the benchmark, then the share is considered to be a *Shari'ah*–non-compliant share; and vice versa. The established benchmarks are 5, 10, and 25 percent.

In a nutshell, *Shari'ah* compliance is not only established by looking at the contract in the abstract. It is also developed by application of *fiqh al-muwazanah*, which plays an important role in demonstrating Islam's flexibility and ability to adapt to changing conditions and circumstances and to accommodate people's changing needs and interests.

8. RECTIFICATION OF A *SHARI'AH*–NON-COMPLIANT CONTRACT

When a dispute arises that may lead to *Shari'ah*–non-compliance risk, a process of rectification should be undertaken. There are two approaches used to rectify the contract, depending on the level of error or defect. If the defect is considered critical, it will render the contract *batil* (void). If the contract contains a reparable error, it will render the contract *fasid* (defective). Each category has a different method that should be employed to rectify the harm of *Shari'ah*–non-compliance: one method is correction and the second is purification of income.

8.1 Correction

Shari'ah–non-compliance may arise when there is an error or defect in clauses and terms, such as the date or year of the contract, using a *Shari'ah*–non-compliant term such as interest, or stipulating a capital guarantee in *mudarabah*. According to Hanafi jurists, the presence of such errors and violations make the contract defective (*fasid*) rather than void (*batil*). Hence, if such elements are removed or rectified, the contract becomes valid. The legal position of such a contract depends upon whether the goods have been delivered or not. For example, if the subject of a sale, not previously identified, is mutually identified, the sale contract becomes valid. If a lender has put the condition of interest in a loan contract, the condition is invalid, but if this condition is removed, the contract becomes valid.[61] If the buyer in a *fasid* sale, for example, takes possession with the consent of the seller, the transfer of ownership takes place. It is mentioned in *al-Majallah*: "In a fasid sale in which the buyer has received the object with the permission of the seller, he becomes the owner."[62] However, the parties still have the right to revoke the contract.

There are many factors that render a contract defective (*fasid*) so that it needs to be rectified. The following are a sample only; they are not exhaustive:[63]

- Defective consent. According to the majority of jurists, a contract conducted under coercion is void (*batil*). However, according to Hanafi jurists the contract is defective (*fasid*) and will be deemed valid after rectification.
- Lack of any relevant information. The lack of information that will affect the validity of contract can be related to the subject matter, such as an unidentified asset in an *ijarah* contract; or it may be related to the counter-value, such as a price that is kept subject to change, and so on.
- A defect due to stipulation of any invalid condition; for example, one that conflicts with the purpose of the contract, or with standard commercial practice, or with a *Shari'ah* principle.

In short, if there is a dispute that may lead to *Shari'ah*–non-compliance risk arising from a simple mistake or an avoidable error, the IFI should rectify and remove the error. The IFI need not necessarily nullify the contract and restart the process from the beginning. That is because, since the error has been rectified, the contract becomes valid; thus all the contract's effects will then be operative.

8.2 Purification of Income

Unlike a reparable defect, if the terms and conditions of a contract contain a serious violation of the pillars, such as the bank not owning the asset in BBA financing, or not transferring ownership in a contract of sale, or if the proper sequence of contracts is not followed, then the contract becomes void (*batil*). As discussed earlier, a void contract does not produce any legal effect. Hence, any income generated from this contract is not permissible and should be returned or donated to charity. If the seller has delivered the subject matter to the buyer, he should return it to the seller. Likewise, the seller should return the price paid to the buyer including any profit. If the buyer has sold the asset to a third party after taking delivery, the original seller cannot be prevented from claiming the good. The reason is that ownership cannot be transferred through a void contract.[64]

In the context of IFIs, when a dispute occurs and a judge has ruled that the product is not *Shari'ah* compliant due to a critical defect, the IFI should purify its income. It is not permitted to recognise the profit or income generated from that invalidated contract. If both parties want to try to proceed with the transaction in a *Shari'ah*-compliant manner, a properly structured contract will have to be drawn up from the beginning, in place of the void one.

9. MITIGATION OF *SHARI'AH*–NON-COMPLIANCE RISK

As *Shari'ah*–non-compliance has a negative impact for IFIs, all necessary actions should be taken in order to avoid or mitigate the risk of noncompliance. Some proposed mechanisms to mitigate *Shari'ah*–non-compliance risk, among others, are:

- The clauses and terms of the contract should be prudently and carefully reviewed for *Shari'ah* compliance.
- Care should be taken that the legal documentation matches *Shari'ah* requirements.
- *Shari'ah* research, *Shari'ah* review, *Shari'ah* audit, and risk management assessment should be conducted for every product to be launched.
- The risk management committee should have a clear understanding of the *Shari'ah* requirements and risks associated with IFI activities.
- The internal *Shari'ah* review should work closely with the *Shari'ah* board.
- IFIs should have sound *Shari'ah* risk management frameworks in order to understand the causes of risk and the way to mitigate it.
- Clear policies should be set and procedures followed regarding the approval of products and services that require adherence to *Shari'ah* principles.

In addition, *Shari'ah* advisers play a central role in assuring that the IFIs' products and services are in compliance with *Shari'ah* rules and principles and in ensuring that the terms and conditions in legal documentation do not contain any defects or violations of the pillars of the contract. *Shari'ah* advisers are considered to be the IFIs' clients' advocates in ensuring that the clients have the benefit of *Shari'ah* compliance as a key part of good quality services from IFIs. They thus hold a great responsibility in ensuring that the trust of the IFIs' clients is honoured, and they assume the key role in safeguarding public confidence in the Islamic finance system and its products.[65] Therefore, *Shari'ah* advisers should be given more access to the relevant information about IFIs' products and services, in order to be able to review and scrutinise them comprehensively.

10. CONCLUSION

Shari'ah compliance is the backbone of IFIs in assuring their integrity and credibility. This is a unique characteristic of IFIs, since *Shari'ah* must be the substance of and provide guidance for their day-to-day operations

and activities. Compliance with the *Shari'ah* will boost the confidence of IFIs' shareholders as well as the public, which in turn will affect the profitability of IFIs business in the future through the public's investment of funds with them. Conversely, failure to adhere to *Shari'ah* principles and rules will render IFIs noncompliant with the *Shari'ah*. The existence of noncompliant elements will not only affect the confidence level of IFIs' shareholders and the public, but in addition to *Shari'ah*–non-compliance risk and the associated reputational risk may also expose IFIs to various other risks of losses. Hence, all necessary measures should be taken to mitigate *Shari'ah*–non-compliance risk and avoid resultant financial losses.

Currently, efforts at *Shari'ah* compliance are still focusing more on technical requirements of contracts reflected in the clauses and terms of legal documents. Most cases of default in the industry indicate that *Shari'ah*–non-compliance risk generally arises from the possibility of a judge's ruling that the underlying contract in a product is invalid.

Moving forward, the *maqasid al-Shari'ah* approach should also be given more emphasis as a dimension for assessing *Shari'ah*–non-compliance risk. This is because IFIs have come into existence in order to achieve the objectives of the *Shari'ah*, particularly the preservation of wealth (*hifz al-mal*). Hence, *maqasid al-Shari'ah* should be a part of risk management assessments. The economic and social impact of Islamic finance operations should be considered when evaluating products for *Shari'ah* compliance. In other words, having *Shari'ah*-compliant products is the *means* (proper instruments) in our effort to achieve the objectives (*maqasid*) of the *Shari'ah* in producing a good economy marked by the spirit of brotherhood (*ukhuwwah*), cooperation (*ta'awun*), social equality and justice (*'adalah*), just and fair allocation of resources, protection of the environment, elimination of poverty, and helping society to achieve well-being (*maslahah*).

NOTES

1. Michael Mahlknecht, *Islamic Capital Market and Risk Management*, *Global Market Trends and Issues* (London: Haymarket House, 2009), 75.
2. Al-Tirmidhi, *Sunan al-Tirmidhi*, 2nd ed. (Egypt: Shirkat Maktabat wa Matba'at Mustafa al-Babi al-Halabi, 1975), 4:668, *hadith* no. 2517.
3. Yusuf (12): 43.
4. Yusuf (12): 46.
5. Wahbah Zuhaily, *Tafsir Munir* (vol. 7) (Damascus: Dar al-Fikr, 2003), 10.
6. Ahmad ibn Muhammad Al-Shawi, *Hasyiyah al-Shawi 'ala Tafsir al-Jalalayn* (vol. 2) (Beirut: Dar Kutub al-Ilmiyah, 2006), 180.

7. In finance and economics generally, risk is defined as the degree of variability of the possible values of an outcome, and is typically measured by its variance or its standard deviation. The risk of loss is referred to as "downside risk." Excessive variability is considered as *gharar* in *fiqh al muamalat*.
8. Sami al-Suwailem, *Hedging in Islamic Finance*, *Occasional Paper of the Islamic Development Bank*, No. 10 (Jeddah: IDB, 2006), 56.
9. Abu Dawud, *Sunan Abu Dawud* (Beirut: Dar al-Kitab al-'Arabi, n.d.), 3:302, *hadith* no. 3505; al-Tirmidhi. *Sunan al-Tirmidhi*, 3:534, *hadith* no. 1232; al-Nasa'i, *al-Sunan al-Kubra*, *hadith* no. 6205; (d) Ibn Majah. n.d. *Snan Ibn Majah* (Beirut: Dar al-Fikr, n.d.), 2:737, *hadith* no. 6205.
10. Anas bin Malik. 2004. *al-Muwatta'* (Abu Dhabi: Mu'assasat Zayed bin Sultan al-Nahyan, 2004), 4:960.
11. Abu Sa'eed said, "Allah's Messenger (pbuh) prohibited us from two types of sale and two types of dress. He forbade us from *mulaamasah* and *munaabathah* in sales. *Mulaamasah* is when one man touches the cloth of the other by night or day without any further inspection of it. *Munaabathah* is when each man throws his garment to the other, and by doing so the sale is completed, without any inspection, and even if one or both is not satisfied with what he received." (Sahih Muslim, no. 3613 [Siddiqi trans.])
12. Ibn al-Qayyim, *Zad al-Ma'ad fi Hady Khair al-'Ibad* (Beirut: Mu'assasat al-Risalah, n.d.), vol. 5, 723.
13. Hassan, H.H. (2009), "Basic Sharia Principles Governing Risk Management," in Dusuki, Asyraf Wajdi (ed.), *Islamic Financial System, Principles and Operations* (Kuala Lumpur: ISRA-CAGAMAS, 2011), 555.
14. Muhammad Uthman Shibir, *al-Qawa'id al-Kulliyah wa al-Dhawabit al-Fiqhiyyah fi al-*Shari'ah *al-Islamiyyah* (Amman: Dar al-Nafais, 2007), 312.
15. See Al-Sharbini, *Mughni al-Muhtaj* (al-Makabah al-Shamilah), 6:441, and Ibn Qudamah, *al-Mughni* (Beirut: Dar al-Fikr, 1405 AH), 4:124.
16. Shibir, op. cit., 312.
17. Imam Muslim, *Sahih Muslim* (Beirut: Dar Ihya' al-Turath al-'Arabi), 4:1836, *hadith* no. 2363.
18. Siddiqi, M.N., Risk Management in Islamic Framework. Paper submitted for Harvard-LSE *Workshop on Risk Management*. London School of Economics, February 26, 2009.
19. Nevertheless, the principle that the wealthy should not be allowed to enjoy a pure rent on their money at the expense of those who create wealth by their work is hardly reflected in the practice of profit sharing and loss bearing investment accounts in Islamic banks, as the banks' shareholders (the "entrepreneurs") are generally more wealthy than the investment account holders.
20. Al-Qurtubi, *Al-Jami' li Ahkam al-Qur'an*, 16:10; Zaydan, *al-Madkhal li Dirasat al-*Shari'ah *al-Islamiyyah*, 38.
21. The full text of *hadiths* reads: "A person will not be able to take a step on the Day of Judgment until he is asked about his life and how he spent it; his knowledge and how he acted upon it; his wealth and how he acquired it and spent it; and his body and how he used it" (*Sunan al-Tirmidhi*, 4:612, *hadith* no. 2417).

22. A person or entity legally prohibited to enter into any financial contract because of bankruptcy, etc.
23. Ali Muhyiddin al-Qarah-Daghi. 2006. *al-Muqaddimah fi al-Mal wa al-Iqtisad wa al-Milkiyyah wa al-'Aqd: Dirasah Fiqhiyyah Qanuniyyah Iqtisadiyyah* (Beirut: Dar al-Basha'ir, 2006), 510–513. In the case of *salam*, *gharar* is mitigated by virtue of the fungible nature of the commodity specified in the contract, and in *istisna'a* by a detailed specification of the subject matter.
24. *Bada'i' al-Sana'i'*, 5:136; *Hashiyat Ibn 'Abidin*, 4:5; *Fath al-Qadir*, 5:80, *Mughni al-Muhtaj*, 2:5, *Hashiyat al-Dasuqi*, 3:5, *Nihayat al-Muhtaj*, 3:8–10.
25. Rosly, Saiful Azhar, *Islamic Capital Market* (Kuala Lumpur: INCIEF, 2010), 20–24.
26. Surah al-Nisa', (4), 29.
27. AAOIFI, *Governance Standards for Islamic Financial Institution No. 1:* Shari'ah *Supervisory Board: Appointment, Composition and Report* (Manama, Bahrain: AAOIFI, 2010), 4.
28. See AAOIFI, *Governance Standard for Islamic Financial Institution No. 2:* Shari'ah *Review* (Manama, Bahrain, AAOIFI, 2010), 14.
29. Ibid., 15–16.
30. For details, see AAOIFI *Standard on Auditing*, no. 4, 43.
31. IFSB, *Guiding Principles on* Shari'ah *Governance Systems for Institutions Offering Islamic Financial Services* (Kuala Lumpur: IFSB, December 2009).
32. IFSB, *Guiding Principles of Risk Management for Institutions (Other Than Insurance Institutions) Offering Only Islamic Financial Services* (Kuala Lumpur: IFSB, 2005), 26.
33. Ibid.
34. For details, see IFSB (2009), 27.
35. A. S. Rosly, A. Lahsasna, and M.A. Naim, "*Shari'ah* Risk and Clawback Effect of *Al-Bai Bithaman Ajil* in Default", *Journal of Islamic Accounting and Business* (submitted), 2.
36. Asyraf Wajdi Dusuki (ed.), *Islamic Financial System, Principles and Operations* (Kuala Lumpur: ISRA-CAGAMAS, 2011), 445.
37. "Sukuk Still a Niche Despite Huge Potential," 20/05/2010. Retrieved from www.sukuk.me/news/articles/73/Sukuk-still-a-nich-despite-huge-potential.html.
38. Fakihah Azahari (2009), "Islamic Banking: Perspectives on Recent Case Development." Retrieved from www.itreasury.net/html/download/MLJ%20Article.pdf
39. Wahbah al-Zuhaily, *al-Fiqh al-Islami wa Adillatuhu* (Damascus: Dar al-Fikr, 2004), 4:3086.
40. Muhammad, Ayyub. 2007. *Understanding Islamic Finance*, 118. West Sussex, UK: John Wiley & Sons.
41. Al-Zuhaily, op.cit., 4:3087.
42. *Fath al-Qadir ma'a Sharh al-'Inayah*, 5:985; *Hashiyat Ibn 'Abidin 'ala al-Durr al-Mukhtar*, 4:503; *al-Bahr al-Ra'iq*, 5:277.
43. Zuhaily, op. cit., 4:3089.
44. Ibid.
45. Ibid.

46. Muhammad, Ayyub, op. cit., 121.
47. Zuhaily, op. cit., 4:3090.
48. Quoted from Sa'ud bin Saleh Athishan, *Minhaj Ibn Taymiyyah fi al-Fiqh*, (Riyadh: Maktabat al-'Ubaykan, 1999), 67.
49. Yusuf al-Qaradawi, "Minhaj Fiqh al-Muwazanah fi al-Shar' al-Islami (Dirasah Usuliyyah)," *Majallah al* Shari'ah *wa al-Dirasat al-Islamiyah* 16, no. 46: 380 [Jamad al-Akhir 1422 AH/Sept. 2001].
50. Abdullah Kamali, *Maqasid* Shari'ah *fi Daw Fiqh al-Muwazanat* (Beirut: Dar Ibn Hazm, 2000), 125–126.
51. *Majallat al-Ahkam al-'Adliyyah* (*al-Majallah*), article 27.
52. *Al-Majallah*, article 2.
53. Ibid., article 28.
54. Ibid., article 25.
55. Shibir, op. cit., 182.
56. *Al-Majallah*, article 29.
57. Ibid., article 20.
58. Wahbah al-Zuhayli, *Nazariyyat al-Darurah al-Shar'iyyah Muqaranatan Ma'a al-Qanun al-Wadi'* (Beirut: Mu'assasat al-Risalah, 1985), 68.
59. *Al-Majallah*, article 22.
60. Bank Negara Malaysia, *Resolusi Syariah Dalam Kewangan Islam*, 2nd ed. (Kuala Lumpur: Bank Negara Malaysia, 2010), 72.
61. Ayyub, op. cit., 118.
62. *Al-Majallah*, article 371.
63. Ayyub, op. cit., 120–121.
64. Ibid., 124.
65. Mohamad Akram Laldin, "*Shari'ah* Governance in Islamic Financial Services," *Isra Bulletin*, no. 3 (August, 2009): 4–5.

CHAPTER 12

Supervisory Implications for Islamic Finance: Post-Crisis Environment

Peter Casey
Dubai Financial Services Authority

1. REGULATION AND SUPERVISION

This chapter discusses the implications for supervision of the risks involved in Islamic finance, with a particular focus on Islamic banking and developments since the financial crisis. It covers *takaful* to a limited extent only.[1] In so doing, it is necessary to keep in mind the distinction which some draw between supervision and regulation. Where this division is drawn, "regulation" means the process of creating a set of laws and rules applicable to the activity in question; "supervision" means ensuring that those laws and rules are complied with, currently and prospectively. It is in essence the distinction between the activities of the legislator and the policeman. This is to some extent a caricature, because good supervisors are rarely driven solely by rules and, conversely, rules are commonly written in broad terms, allowing supervisors considerable latitude. On the other hand, the scope of supervision is always constrained by rules, if only by the broad objectives and responsibilities assigned to the supervisory authority. The boundary issue is further confused by the fact that the supervisor may itself be the rule maker, to a greater or lesser degree. Nevertheless, its scope of action will be at least partly constrained by external legislative provisions, and generally also by process requirements.

2. SUPERVISORS AND *SHARI'AH*

Section 2 covers aspects of the supervisor's role in *Shari'ah* matters, including *Shari'ah* governance and non-compliance risk.

Islamic Finance: The New Regulatory Challenge.
Edited by Simon Archer and Rifaat Ahmed Abdel Karim
Copyright © 2013 by John Wiley & Sons Singapore Pte. Ltd.
ISBN: 978-1-118-62897-3

2.1 The Supervisor's Role in *Shari'ah* Matters

A very clear example of the interaction between supervision and regulation is provided by the question of the supervisor's role in *Shari'ah* matters. In some jurisdictions (for example, the United States or France), the constitutional separation of the state from religion means that a supervisor is essentially debarred from involvement with *Shari'ah* issues. Other essentially secular regulators will accept that the claim to be Islamic is an important part of the firm's representations to its clients or potential clients, and is subject to the same regulatory provisions as other similar claims, for example to be "green." This in principle provides a basis for supervisory involvement, though in practice such involvement is likely to be limited to the clearest cases of misrepresentation.

At the other end of the spectrum, some jurisdictions (for example, Malaysia or the Sudan), find no conceptual difficulty in establishing a central *Shari'ah* Council that oversees *Shari'ah* matters across the whole of the jurisdiction's Islamic finance industry. Generally, such a model will be supported by *Shari'ah* Supervisory Boards (SSBs) or *Shari'ah* advisers in individual firms, together with systems and controls requirements to ensure that *Shari'ah* decisions are properly implemented across the firm's business, disclosure, audit requirements, and so on.

An intermediate position is for the regulator to require a firm's claim to be Islamic to have a sound basis, but not to make judgments on its substance. In such a system, the regulator may impose *Shari'ah* governance requirements on the firm, covering similar matters to those described in the previous paragraph, but not establish a *Shari'ah* Council. Implicit in this approach is that the supervisor will apply essentially secular approaches, similar to those it would apply in other control areas, to deliver a religiously based result.

Thus the role of the supervisor in *Shari'ah* matters will derive from, and influence, the legal context and the formal regulatory regime. Both may also be influenced by market factors. The most important of these is, of course, the lack of consensus on many relevant *Shari'ah* matters, partly reflecting the relative youth of the modern Islamic finance industry.

Some regulators are understood to have argued that regulation of *Shari'ah* matters is unnecessary in their jurisdictions because of the strength of market discipline in this respect. More commonly, however, regulators have established some central mechanism of *Shari'ah* oversight with the specific aim of bringing uniformity to a market.

The merits of this approach depend on the nature of that market. Within a national, largely retail, market there may well be considerable merit in ensuring a uniform approach to what is and is not acceptable. This is, in effect, product regulation, and the brakes it imposes on innovation may be an acceptable price to pay for uniform competition. But that balance will

be different in an inter-professional market, such as that for corporate *sukuk*. It will also be different where the market is highly porous, either in the sense that products can enter freely from outside or in the sense that most products are exported. There is little merit in one country imposing its own standards on products if they will mainly be sold into countries with different national approaches.

2.2 *Shari'ah* and Conventional Governance

The whole area of *Shari'ah* governance is likely to become more difficult for supervisors as the expansion of Islamic finance creates an increased need for *Shari'ah* advice. There is a tricky balance to be struck between having scholars of the highest competence, having scholars who can devote enough time to the issues in each firm, and ensuring reasonable consistency of approach, especially between firms competing in the same market.

At the same time, the crisis has raised the level of supervisors' interest in the governance of the firms—especially banks—that they supervise. A normal position of supervisors is that one and only one body—normally the board of directors of the firm—must be responsible for its overall governance. This of course raises the issue of the position of the SSB. Most supervisors have been able to become comfortable with this on the basis that the SSB is ultimately advisory to the board, and broadly analogous to, say, an Audit and Risk Committee. This is, however, in tension with the insistence of most SSBs that their rulings are mandatory, and must be followed. In practice, these tensions have never come to a head[2] in any way that would trouble supervisors, mainly because SSBs generally act in a responsive way: that is, they rule on propositions put to them by the company's management. That position could change if SSBs took a more activist role, and especially if they moved beyond products and transactions to wider firm issues, for example remuneration.

2.3 *Shari'ah*–Non-compliance Risk

One major unknown in all this is the scope of *Shari'ah*–non-compliance risk: the risk arising from the possibility that a product or transaction that should have been compliant will be found noncompliant. One view is that it is broadly akin to legal risk: something that may have a material impact on the financial position of the firm, but would be unlikely to precipitate failure. Another view is that it represents a higher level of risk, in that a major *Shari'ah* failure might lead investors to desert (especially) a bank in sufficient numbers to cause a run. My own view is that the risk of a run would be very

limited in any institution that had some proper basis for its claim to compliance, even if it proved to be wrong. Investors would be more likely to drift away than to run. The possibility of *Shari'ah* risk does, however, pose a question for those supervisors that for one reason or another forego involvement in *Shari'ah* matters; they will have difficulty in evaluating the risk, and their only tool for mitigating it will be to set additional capital requirements under Pillar 2 of Basel (or some equivalent).

3. LESSONS OF THE CRISIS AND REGULATORY RESPONSES

Many others have written at great length about the lessons for regulators and supervisors from the global financial crisis. Some of the lessons are still being worked out, and some of the initiatives launched in the early days of the crisis already appear to be losing impetus.

3.1 Macroprudential and Systemic Issues

One such is macroprudential regulation. It is amply demonstrated that behaviour which, in a single institution, can be adequately addressed through normal supervisory tools, may not be so addressed when it occurs across an entire financial system. Rapid credit expansion leading to asset price bubbles is the obvious example. Whereas conceptually it is not the *only* example, the attempt to find diagnostics for emerging macroprudential problems has narrowed down essentially to this one case, and the search for policy tools, other than those of macroeconomic policy generally, has all but foundered. One key problem has been that the application of some macroprudential tools would be politically difficult in a single country, and would require an unprecedented degree of political consensus to apply throughout a global financial system.

However, there will undoubtedly be a renewed regulatory emphasis on systemic stability, after a period when advanced countries largely believed that systemic threats had been conquered. More broadly, there has been a shift in regulatory philosophy away from one of perfect markets, in which prudential regulation was justified only by relatively limited economic externalities, to one in which it is recognised that markets can be dangerously imperfect for long periods,[3] and that firms are not always well managed in the interests of their shareholders. Whilst this has not yet led to a coherent new philosophy of regulation, along with the changes in the political climate it has certainly led to a shift in the dynamic of regulation. One element of this is a more intrusive style of supervision, which will affect Islamic firms as much as conventional ones.

3.2 Capital and Liquidity

International standards have been revised with, in particular, a new version of the Basel Accord. Predictably, this involves more demanding standards for both the quality and the quantity of bank capital. It also involves stress testing and, very significantly, new attempts to impose standards for liquidity. The difficulty of defining good liquidity standards, and the belief that problems could be dealt with through lender-of-last-resort arrangements, had previously deterred regulators from going too deeply into this subject. It remains difficult, but its importance is now recognised. Even (or perhaps especially) if regulatory standards are imperfect, it will be a pressing topic for supervisors. Islamic institutions may have particular problems in this area, because of the limited supply of liquid instruments available to them, and the underdeveloped state of Islamic money markets (a problem that is difficult to solve in a way that is *Shari'ah* based in substance rather than marginally *Shari'ah* compliant in form).[4] Initiatives are under way to increase the supply of high quality Islamic financial instruments and, in parallel, to define structures within which these can be used as collateral for liquidity provision. Nevertheless, liquidity is likely to remain a supervisory issue for the foreseeable future.

The increased focus on systemic stability has led to attempts to define and apply higher levels of regulation to systemically important financial institutions (SIFIs). This carries difficulties, for example around arbitrage between SIFIs (as defined) and near-SIFIs. No Islamic institutions will at present qualify as SIFIs at the global level, though there will be a few that will qualify within their home jurisdictions. They will be subject to an increased level of scrutiny, and possibly increased capital requirements.

3.3 Recovery and Resolution

Islamic institutions are also likely to be subject to new arrangements for recovery and resolution if they get into difficulties. Much of the debate on resolution arrangements has so far focused on so-called living wills and potential requirements on SIFIs to structure themselves in ways that permit orderly resolution; this may lead to banks making greater use of subsidiaries rather than branches. However, the standard adopted by the Financial Stability Board in November 2011[5] goes well beyond that. It expects each jurisdiction to create or designate an administrative authority with a broad range of powers and options to resolve a financial institution that is no longer viable. The resolution regime should allow for a sale or transfer of the shares in the firm or all or parts of the firm's business to a third party, creditor-financed recapitalisation of the entity (so-called "bail-in within resolution"), and the wind-down of all or parts of the firm's business. The resolution

authority should be able to act before a firm is balance-sheet insolvent, and to override the voting rights of shareholders. It should respect the hierarchy of claims that would apply in a liquidation, including protecting those covered by deposit insurance or similar arrangements.

For these arrangements to work, they will need to work across borders, in jurisdictions where global SIFIs (G-SIFIs) have major operations, not merely in their home countries. In any event the arguments for such arrangements apply quite strongly to local as well as global SIFIs. Furthermore, once a jurisdiction adopts such a resolution framework, the local pressures are likely to lead to its use in failures of firms other than SIFIs. Few jurisdictions will be able to justify creating a separate resolution authority, and it is likely that in many cases the responsibility will be given to the supervisory authority.

These developments raise several issues for Islamic institutions (including Islamic windows and subsidiaries of conventional institutions). Thinking about corporate insolvency in the context of *Shari'ah* law is at a relatively rudimentary level.[6] However, one standard *Shari'ah* principle is that all unsecured creditors rank *pari passu*, which clearly limits the ability to establish a hierarchy of claims. Furthermore, while some trade-based Islamic contracts (e.g., *murabahah*) create a debt, others, typically investment-based contracts like *mudarabah*, do not. An Islamic bank might well be holding funds provided on both bases, for example short-term interbank placements under commodity *murabahah* and retail profit-sharing investment accounts (PSIA) under *mudarabah*.

In some jurisdictions, the potential interactions between *Shari'ah* and civil- or common-law systems may introduce further uncertainty into the resolution process. In any event, establishing a hierarchy of claims will force a view to be taken on whether holders of PSIA should or should not be given the protection normally afforded to depositors. If not, this will need to be clear to them from the beginning. Imagine, for example, that a conventional bank with an Islamic window is put into resolution. If the question has not been addressed in advance, the resolution authority will need to decide, under highly stressed conditions, whether PSIA holders of the window should be given parallel treatment to that given to conventional depositors, how a wholesale funding contributed under *wakalah* or *murabahah* should be treated, and so on. There is much thinking to be done in this area.

3.4 The Scope of Regulation

Another major focus following the crisis has been on ensuring that all financial institutions that might have an impact on systemic stability are appropriately regulated. After a period of considerable uncertainty, the focus has centred on those non-bank institutions where credit creation may take

place ("shadow banking"). In general, these have been much less a feature of Islamic than of conventional banking, but supervisors will clearly be taking a wider view of group structures and related entities than they have done in the past.

3.5 The International Standards Architecture

Among the most important post-crisis developments have been the changes in the international standards architecture led by the Financial Stability Board (FSB) as the agent of the (expanded) G20. The FSB now clearly leads, and to some extent directs, other standard-setters such as the Basel Committee. It has also become the main driving force for standards implementation, though working closely with other bodies such as the International Monetary Fund (IMF) and the World Bank. This has important implications for the Islamic finance standard-setters, which go beyond the scope of this chapter. The international pressure for standards implementation is, however, important. It will, no doubt gradually, lead to greater, though still imperfect, convergence in both the standards applied and supervisory practices. The focus will, of course, be on the standards endorsed by the FSB, which will in turn be those of the main conventional standard-setters. Even those regulators who implement special standards for Islamic finance are likely to base them largely on their conventional counterparts.

4. THE ISSUES FOR SUPERVISORS

Section 3 discussed some important developments occurring at an international level. Section 4 discusses the implications of these developments for supervisors working in Islamic finance.

4.1 Common Ground between Islamic and Conventional Finance

The first point to note in any discussion of this kind is that many of the priorities and issues for supervisors in Islamic finance will be the same as in conventional finance. For example, any supervisor will evaluate the ownership of a financial institution, with a particular focus on integrity, but also on matters such as whether the financial needs of a parent company might place strains on a subsidiary. A supervisor will also evaluate the fitness and propriety of the board and senior management, and governance matters such as the existence of proper compliance and risk management arrangements. The scope of this scrutiny may be extended if the supervisor has a role in *Shari'ah* governance. For example, the evaluation of fitness and propriety

may be extended to members of an SSB. But this will not detract from the common core applicable to both conventional and Islamic business.

Broadly similar comments could be made in other areas, for example the management of conflicts of interest especially around securities dealing. In particular, a core activity of any banking supervisor is the evaluation of credit controls, and of provisioning for credit defaults. Such work is just as important in Islamic banking. Indeed, in certain areas it may be more important, since the bias towards forgiveness of debtors may make it harder, for example, to repossess a house that is the subject of a mortgage.

In capital markets supervision, there may be even less distinction at the supervisory level between conventional and Islamic finance. An obvious example would be an Islamic fund, using a third-party Islamic screen to select its investments. Whilst the supervisor might well have an active role in considering the screening method and the disclosures to be made to potential investors, once the fund is in operation the *Shari'ah* issues are likely to be minimal, and the main supervisory concerns will be matters such as safe-guarding of the fund assets, asset valuation, and general governance. There will be very little difference from the approach taken towards a conventional long-only fund.

4.2 Strategy and Governance

In the post-crisis environment, supervisors can be expected to take a more active interest in business strategy, including both markets and funding. The latter will be subject to more sceptical scrutiny than has been the case in the past. The potential for wholesale market runs on banks came as something of a shock to regulators during the crisis, and led to the Basel Committee's attempt to develop a Long-term Stable Funding Ratio as part of its new liquidity package. There is considerable scepticism as to whether the Committee has got this right, and full implementation has been delayed in favour of an extended monitoring period. The absence of a firm standard may, however, simply increase the intensity of supervisory interest. The scepticism about wholesale market funding is likely to force Islamic banks to rely more on organic growth from their retail investors, in contrast to the immediately pre-crisis period when new Islamic banks were launched in the expectation that much of their funding would be wholesale. This will tend to benefit the more established players, including established conventional banks with Islamic windows.

Related to strategy is the issue of governance. (Remuneration is also related, but has few if any features peculiar to Islamic finance.) Despite the difficulties of doing so, supervisors will need to consider whether their institutions are well governed, with a particular eye to how risks are assumed

and managed. This will involve careful consideration of the part that an SSB plays in governance, and whether it adds to or subtracts from good governance. The prudential issues are, for the present, considered more important than the conflicts of interest between institutions and their customers, so elements of governance that bear dominantly on the latter, like the IFSB's proposal for a Governance Committee,[7] may be considered less important for the present. Nevertheless, the unique set of conflicts of interest created by Islamic finance structures remains one of the distinctive supervisory issues.

4.3 Capital and Liquidity

In addition to the stability of firms' long-term funding, there will also be a greater supervisory focus on shorter-term liquidity. As already noted, this will be a challenge for some Islamic banks, because of the limited supply of secure liquid instruments available to them. Various pieces of work are under way, both nationally and internationally, to increase the supply of highly rated *sukuk*, and also to develop tools for short-term liquidity support. However, the restricted choices available to them mean that Islamic banks may have to accept lower rates of return on their liquid assets than comparable conventional banks. Also, the need for instruments carrying minimal risk to capital or return means that government initiatives are likely to focus on *sukuk* economically as close as possible to conventional bonds; the pursuit of innovative *sukuk* offering new combinations of risks and returns will be left to the private sector.

As new capital regimes are introduced, regulators and supervisors will inevitably need to consider again the relationship between PSIA and deposits. The issues here are well known. The *Shari'ah* basis of a PSIA is that both return and principal are at risk, but in practice banks may not disclose these risks clearly to customers, and commonly create mechanisms to mitigate them. In addition, unrestricted PSIA typically involve maturity transformation, so if investors begin to withdraw money in search of better returns elsewhere, there will be liquidity reasons as well as commercial reasons to support the rate of return. So far as capital adequacy is concerned, the resulting concept of "displaced commercial risk" may be expressed through a parameter—α in the IFSB's capital adequacy standard—that modifies the normal calculation of risk-weighted capital. In a climate of regulatory conservatism, regulators may be more likely to treat unrestricted PSIA as pure deposits both for capital adequacy purposes (effectively setting $\alpha = 1$), and also for depositor protection purposes. The latter might be influenced by a view that, if an Islamic bank fails, the political pressures to compensate retail PSIA holders may not be materially different from the

pressures to compensate depositors in a conventional bank. They will also have in mind that depositor protection is considered to have a preventive function, reducing the likelihood of a (retail) run on the bank.

In implementing the Basel Accords, supervisors in the countries where Islamic finance is strong are likely to concentrate mainly on standardised approaches, reflecting the limited capacity of domestic banks to use more model-dependent approaches and increased supervisory scepticism about internal models. In any event, relatively few Islamic banks have the track record and the long data series needed to gain supervisory approval for model-based approaches.

Of much greater relevance is likely to be the handling of operational risk, whether through set Pillar 1 capital charges or through Pillar 2 risk review and the setting of individual capital requirements. A particular issue here will be the handling of *Shari'ah*–non-compliance risk: in this context, the risks that the effects of contracts will be different from those expected because of *Shari'ah* deficiencies, and that perceived *Shari'ah* deficiencies will cause Muslim customers to shun the institution. Of these two components, one is closely akin to legal risk, the other to reputational risk. In principle there is nothing conceptually new here. The issue for supervisors will be, however, to gauge the scale of the risks, in a situation where there is very limited experience available. In particular, there is little jurisprudence on *Shari'ah* challenges to financial sector contracts and, where there is, it is not always easy to extrapolate into a different national legal environment. In these circumstances, supervisors may take widely different views of the potential scale of *Shari'ah*–non-compliance risk, and possibly apply widely different capital charges for it. It will be some time before any objective basis is available to assess this risk outside a few jurisdictions with well-developed Islamic finance industries.

4.4 Group Supervision

Several elements of the crisis have increased the emphasis on group supervision. This of course includes group consolidation, that is, the application of capital adequacy standards at the level of the group rather than only to individual entities, but it is not limited to that. It also includes consideration of risks at the group level, plans for resolution of the group, and arrangements for supervisory collaboration and exchange of information, usually through what is called a supervisory college. There are of course many issues around group supervision, and this chapter discusses only those that bear particularly on Islamic finance.

The effects of group consolidation are to apply a single set of capital standards at the level of the group. These will be in the hands of the lead supervisor, where the institution is headquartered. Islamic windows or

subsidiaries will therefore need to maintain, or be able to convert, their accounting records into the standards accepted by the lead supervisor, which are most likely to be based on International Financial Reporting Standards (IFRS) or U.S. Generally Accepted Accounting Principles (GAAP). More importantly, lead supervisors will take their own view of the capital to be held in respect of Islamic transactions and structures, for example PSIA. To the extent that these are significant in group terms, therefore, their treatment by lead supervisors will be at least as important as their treatment by the solo supervisor of the individual entity in question. The default position of conventional supervisors will presumably be to treat them as deposits, which will place some pressure on Islamic finance supervisors to justify a different approach.

The existence of supervisory colleges, and participation in them by Islamic finance supervisors, will also have impacts. It has the potential to bring the discussion of Islamic finance into the mainstream of everyday supervisory work, but will also expose regulatory and supervisory practices to international scrutiny and debate. For example, previously purely conventional supervisors may need to understand, and Islamic finance supervisors to explain, the role of an SSB in governance.

4.5 The Impact of the New Standards Architecture

More generally, the new supervisory architecture has created a new level of international pressure for standards implementation, especially implementation of the Core Principles of the Basel Committee, the International Organization of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS). In addition to the well-established reviews by the IMF and the World Bank, the FSB is managing its own programme of peer reviews, and pressing the standard-setters to monitor standards implementation among their members.[8] These reviews cover supervisory practice as well as the formal regulatory provisions. Like participation in colleges, they will create a greater degree of international convergence, and force discussion of how far Islamic finance should be treated differently from conventional finance. As yet, the standards of the specifically Islamic standard-setters are not included in such reviews, and the onus will therefore be largely on supervisors themselves to articulate their approach.

4.6 The Challenge for the Future

For the future, the challenge for supervisors will be to keep up with innovation in Islamic finance. Whilst in conventional finance the challenge is likely to come from new and exotic products, in Islamic finance it may well come from products that are superficially similar to products well-known in

the conventional world, but with differences in their risk characteristics that may not be fully appreciated and whose effects may be unknown.

NOTES

1. I have written at greater length on supervisory issues in Islamic insurance in *Takaful Islamic Insurance: Concepts and Regulatory Issues* (Hoboken, NJ: John Wiley & Sons, 2009).
2. Though it would be interesting to know what the *Shari'ah* committee of The Investment Dar thought of that firm's decision to resist payment on a contract they had approved, on the grounds that the contract was not *Shari'ah* compliant.
3. A macroeconomic version of Keynes's comment that "Markets can remain irrational a lot longer than you and I can remain solvent."
4. An example of *Shari'ah* compliance in form (but arguably not in substance) is the use of commodity *murabahah* for interbank transactions, in which the underlying commodity is immediately resold to produce cash while the *murabahah* mark-up remunerates the party providing the liquidity
5. Key Attributes of Effective Resolution Regimes for Financial Institutions, Financial Stability Board, November 2011: www.financialstabilityboard.org/publications/r_111104cc.pdf
6. A helpful collection of papers is "Effective Insolvency Regimes: Institutional, Regulatory and Legal Issues Relating to Islamic Finance, Islamic Financial Services Board and The World Bank," March 2011, ISBN 978-967-5687-02-0.
7. IFSB. *Guiding Principles on Governance for Institutions Offering only Islamic Financial Services*. December 2006.
8. See, for example, A Coordination Framework for Monitoring the Implementation of Agreed G20/FSB Financial Reforms, Financial Stability Board, October 2011: www.financialstabilityboard.org/publications/r_111017.pdf

PART

Two

Capital Adequacy

CHAPTER 13

Risk and the Need for Capital

John Board and
Hatim El-Tahir

1. INTRODUCTION

The world economy, and financial markets in particular, are at the time of this writing still traumatised by the global financial crisis and its huge macroeconomic effects. Policymakers and regulators around the world are debating the introduction and imposition of new models of financial regulation. Consequently, a major programme of financial regulatory reform was introduced to strengthen capital and liquidity management in the global banking system. The main objective of this initiative is twofold: to uphold confidence in the global banking system and to put in place measures that would prevent or lessen spread of systemic risk to the broader financial systems.

This chapter discusses the key issues that arise in risk and the need for capital. Three key linked themes will be discussed and analysed:

1. Capital.
2. Risk.
3. Strengthening capital and risk management regulation and oversight.

The analysis is structured around these three themes in four main sections. After the introduction, an overview of capital regulation and the evolution of international capital standards is presented. This is followed by discussion on the introduction of the "risk-based regulation" concept, which encompassed the types of risks faced by banking institutions. Before concluding, the chapter touches on two inter-linked development in capital regulation: first, the globalisation of financial regulation and the impact of

Islamic Finance: The New Regulatory Challenge.
Edited by Simon Archer and Rifaat Ahmed Abdel Karim
Copyright © 2013 by John Wiley & Sons Singapore Pte. Ltd.
ISBN: 978-1-118-62897-3

the global regulatory framework proposed in Basel III, which aimed at promoting a more resilient banking sector worldwide; second, the rise and fall of contingent capital instruments used by the global systemically important financial institutions (G-SIFIs). The conclusion presents the key challenges of global standardisation of capital management regulation and the concerns of banks in implementation and compliance.

One of the main lessons learned from the global financial crisis (GFC) is the excessive leverage employed by the internationally active banks, and the subsequent erosion of the capital base of these banks. In addition, the crisis identified the vulnerability of the banks' business models and strategies, and more importantly the banks' vulnerability to financial and economic shocks.[1] Hence, bank supervisory authorities regard capital as a key element in the regulatory framework. For institutions whose liquid assets are a small proportion of their liabilities, banks have traditionally needed to show a good margin of reserves in order to retain the confidence of their depositors and the public. This practice was codified in the 1998 Basel Capital Accord, and more recently in the 2004 Revised Capital Framework, promulgated by the Basel Committee on Banking Supervision (BCBS). The 1998 Accord was justifiably regarded as a regulatory landmark and has had a profound influence on banking institutions around the world. More importantly, the BCBS recently introduced a new major set of reforms to Basel regulations, aimed at addressing global capital regulatory framework in light with the prevailing global crisis—Basel III. The main objective of this development in Basel regulation is twofold: to improve the banking sector's ability to absorb shocks arising from financial and economic stress, and thus reduce the risk of spillover from the financial sector to the real economy. Between 2010 and 2011, the BCBS produced two important policy documents. The first document sets the concept and approach to enhance bank regulation globally. The second addresses the requirements for strengthening liquidity regulation.[2]

The GFC has highlighted not only the importance of the absolute amount of a bank's equity position, but most importantly the *quality* of capital held by a bank. Thus, any attempt to address issues relating to risk and capital regulation cannot overlook the importance of capital adequacy and liquidity risk measurements necessary to improve the level and quality of capital and the ability to withstand liquidity crises. But what exactly is capital? In practice, it can be defined in various ways depending on the source of the question. For the public and the bank depositor in particular, it represents the cushion available to absorb losses. For the accountant, it represents the surplus of assets over liabilities (i.e., equity). For the bank, it represents its share capital and reserves (equity) and nondeposit liabilities, forming a distinction between internal and external capital. This

is also largely how the supervisors see it, though supervisors may differentiate not so much between external and internal capital as between share capital and free reserves on the one hand, and lesser-quality reserves and junior and senior debt on the other.

What is especially critical is that the measure of capital is only accurate if the assets (and liabilities) are on the balance sheet at their fair values. Since capital is only a relatively small part of a bank's balance sheet, it can evaporate rapidly if only a small proportion of its assets are impaired or turn out to be irrecoverable.

The Basel capital ratio is based on a carefully defined numerator (the capital definition) and denominator (the measure of risk). The numerator of the equation, capital itself, is divided into a number of eligible components with different limits and sublimits. The first tier of capital, largely shareholders' paid-up capital built up from retained profits, has to represent at least half of the total measure of capital.

The second tier of capital can be made up from other elements that add to the strength of the bank, such as revaluation reserves arising from unrealised book profits or upwards remeasurement of assets to fair value, general loan-loss provisions under certain conditions, and a subset of liabilities with characteristics of capital, such as hybrids of debt and equity instruments and subordinated term debt.

The denominator of the capital ratio represents the asset base. Under regulatory capital requirements, the assets are weighted according to broad categories of perceived risk. It is important to note that this includes off-balance-sheet as well as on-balance-sheet exposures. Under the original Basel Accord, the on-balance-sheet risk categories were deliberately broad—the Accord used a portfolio approach designed to estimate an appropriate measure of capital.

2. THE EVOLUTION OF INTERNATIONAL CAPITAL STANDARDS

When the Basel Committee first began discussing capital adequacy seriously in the early 1980s, a global standard was far from its thoughts. The committee began with a fact-finding survey, with the intention of comparing the arrangements in different markets and examining whether it might be possible to develop best practice guidelines.

A sequence of events triggered more focused efforts that eventually resulted in the 1988 Accord. The first was the work in the European Community on defining a common capital standard. Then, as the gravity of the Latin American debt crisis of the early 1980s became clearer, many bank supervisors and other

policy makers began to express the view that bank capital standards had been allowed to fall to a level that exposed the world's major banks to a systemic crisis. Supervisors at the Federal Reserve and other U.S. institutions with banking oversight responsibilities were particularly strong voices for change, as they observed the significant burden of the Latin American debt crisis on several large U.S. banks. The Bank of England also saw the gravity of the situation from the perspective of the world's largest financial center.

In response to these events, in the early 1980s U.S. regulators attempted to introduce a tighter capital standard for U.S. banks. However, these efforts ran into strong opposition from the banking industry, which was concerned about possible negative effects of tighter capital standards on their international competitiveness. At the time, Japanese banks were expanding rapidly on the back of a strong domestic market and attempting to increase market share abroad.

A number of high-profile takeovers, or takeover attempts, of U.S. banks by Japanese interests raised protectionist concerns. Policy makers in the U.S. and in other G10 countries concluded that the only way in which the capital levels of the world's principal banks could be raised was through a global agreement. In 1985, the G10 Governors therefore gave the Basel Committee a mandate to report to them on the modalities of achieving agreement among committee members on a minimum capital standard.

By 1987, the committee had held a number of tightly focused meetings in which the main elements of the Capital Accord were put in place. In that year, committee members moved forward with an arrangement in the Accord that would divide capital into two tiers of different quality. By the fall, members reached agreement on an 8 percent risk-weighted capital ratio, 4 percent for each tier, and by December a consultative paper was ready for approval by the G10 Governors. It is important to understand that the level of 8 percent was not selected as a result of calculations of historical non-repayment for default risk, even though the 8 percent ratio was measured against credit risk alone. While somewhat of a judgment call by the supervisors who negotiated the 1988 agreement, the 8 percent ratio was not agreed upon without conducting a considerable amount of testing based on banks' existing capital mixes and balance sheets. In this way it was possible to make a fairly close assessment of the capital ratios of the banks in the G10 countries and to judge what ratio would represent an acceptable level of capital cover.

3. THE RISK-BASED FINANCIAL REGULATION APPROACH

The Basel Committee never regarded the initial Capital Accord as a static measure of capital adequacy. Several times since 1988 changes were

introduced, in respect of the definition of capital (tightening up on the definition of general provisions within Tier 2 and redefining the eligibility of hybrid instruments within Tier 1), the risk weights and the treatment of netting. The most significant revision to the 1988 Accord was the market risk capital amendment of 1996, which allows certain risks such as foreign exchange, security, and commodity trades to be carved out of the credit risk measure and given separate capital charges calculated according to the net uncovered position.

The simplicity of the 1988 Accord was one of its key strengths and one of the reasons for its broad acceptance at a time when international prudential standards in any industry were considered by many to be a novel, if not alarming, idea. But over time its very simplicity became one of its key drawbacks, as the Accord became a target for creative bankers to circumvent. In particular, the institutional approach to risk allocation provided an incentive to remove some high-quality assets that attracted high capital charges from the balance sheet. In the decade following the Accord's introduction, financial markets had become increasingly more complex, with the result that the Accord could no longer credibly assign capital charges in relation either to the risks of these products—such as securitised assets with different tranches of risk and derivatives products—or to the risk mitigation techniques commonly employed by banks. In addition, advances in technology and risk management practices had led to more sophisticated approaches to default and loss estimates, and spoke to the possibility of calibrating capital charges with greater granularity than the broad exposure classifications of the 1988 Accord.

While recognising the need for a capital standard that could address these developments, the committee realised that the standard would also have to remain appropriate for less sophisticated banks both in the developed industrialised world and in economies of the emerging markets that mainly undertake more traditional credit provision functions. This viewpoint influenced the decision to create supervisory options for capital calculations that could be scaled to the sophistication of jurisdictions' banking industries, and even to the sophistication of categories of banks within a jurisdiction. This was clearly beyond the scope of simple amendments to the original Accord, and also argued in favor of an entirely new capital standard.

The limited scope of the 1988 Accord also weighed in the decision to rethink capital standards entirely, rather than add amendments to the original document. Specifically, the objective of the 1988 standard was to provide a general capital cushion against all risks, including market risk, operational risk, interest rate risk, and legal risk. However, the original capital ratio was expressed only in terms of credit risk, because that was

historically the greatest risk for banks and the one that could be measured most simply through a broadly institutional approach. The market had in fact validated this judgment in its own manner—banks were not only expected by equity investors, creditors, and rating agencies to have capital ratios above 8 percent, but those that did not maintain a healthy margin above this level were not regarded as having the highest standing. In the ensuing years, however, the greater complexity of banking institutions and their growing involvement in noncredit activities spoke to the need to design a standard that would separately assess capital adequacy against different types of risk.

Committee members also recognised that while capital adequacy is a vital component of a banking institution's success and viability, the quality of management and of internal controls has consistently proven to be an equally critical element of success. Indeed, these elements can rightfully be viewed as a bank's first line of defence, since experienced management and robust controls can lessen the probability of significant losses that would eat into capital. Committee members thus sought appropriate ways to incentivise banks to continue improving their risk management practices. Clearly, this added goal broadened the scope of the capital framework well beyond that of the 1988 agreement, and further tilted the committee's thinking toward an entirely new standard and away from a patchwork of amendments to the original Accord.

The new framework addresses the expanded goals of the committee by introducing three mutually reinforcing "Pillars." It is critical that all of the Three Pillars are implemented effectively, because the greater freedom provided by the adoption of a risk-based approach requires additional checks and balances.

Pillar 1 consists of minimum capital requirements; Pillar 2, the concept of supervisory review; and Pillar 3, market discipline. The first pillar seeks to align bank capital more closely with the actual risks that banks face, while presenting banks and their supervisors with options that allow the capital rules to be scaled to the level of sophistication. Thus, banks with a more traditional banking business will be able to readily apply more risk-sensitive capital charges using information technology and management practices that are compatible with the complexity of their operations. More sophisticated institutions, however, will be able directly to use aspects of their risk quantification and management techniques in regulatory capital calculations. This will result in capital charges that are more closely aligned with actual risk, and thus provide incentives for all banks to refine their risk measurement practices.

Another important feature of Pillar 1 is the adoption of a specific charge for operational risk. It is fair to say that the concept of operational risk is still

relatively new and the approaches to measuring and managing it are still in a developmental stage, but it is a risk that is already significant and is plainly growing in importance as a direct result of the sheer complexity of modern finance. The intention to adopt a capital charge has given the industry a significant incentive to develop methodologies to address this complex risk.

Pillar 2 recognises the responsibility of the supervisor to promote the overall safety and soundness of the banking system, while also stressing that individual banks have primary responsibility for managing their own risks. Pillar 2 stresses the critical role of dialogue between supervisors and banks, which can serve to provide additional incentives for banks to manage risk in a prudent fashion. Of equal importance under the second Pillar, however, is that by establishing a set of common guidelines for supervisory review, supervisors around the world would implement the new Accord with greater consistency, thereby encouraging a more level playing field and decreasing the regulatory burden on banks operating in different jurisdictions.

Pillar 3 involves the market in the capital adequacy regime. The new Accord stipulates a number of minimum public reporting standards on risk and risk management. These will enhance the ability of market participants to understand each bank's risk profile and the sufficiency of its capital relative to its risk and should enable competitors, analysts, rating agencies, and academics to exert the market discipline required to reinforce the relative freedom in the new Accord. Essentially, the more a bank uses internal methodologies to measure its risk capital, the greater the disclosure requirement will be.

4. GLOBALISATION OF FINANCIAL REGULATION?

An important point to remember about the Basel Accord is that it was negotiated specifically as an agreement between Basel Committee countries, and thus was intended to apply only to "internationally active" banks in these countries. And while in theory the Basel Committee has no legal powers to enforce the Accord, in practice the public endorsement of the G10 Governors and the publicity surrounding the Accord made it difficult for the then G10 countries to evade it. The process has been eagerly embraced by the credit rating agencies, which enthusiastically used the Accord as a means of comparing different banks. Expressed in different words, the delivery of a common measurement tool has provided additional market discipline in an industry for which systemic risk is an ever-present threat.

Over the years, the Basel Accord has had a significant influence on banks, supervisors, and investors around the world, initially in the G10 and OECD countries, but in recent years even more broadly, with well over

100 countries eventually adopting the original capital standard, and the full support of the wider G20. The risk-based financial regulation concept gained recognition internationally and was adopted in many developed and emerging economies. The Accord has clearly led to the strengthening of capital standards among the world's banks, particularly the large, internationally active banks for which it was intended, and has also led to a more level playing field by ensuring against slides in prudential standards in any one country that could in turn lead to competitive imbalances.

Building on the Three Pillars of the Basel II framework, the newly developed Basel III continued to supplement the risk-based approach and designed new set of regulations to promote a more resilient banking sector in three key areas: First, it aimed to raise the quality, consistency and transparency of the capital base of banks. In doing so, Basel III stipulated that "banks' risk exposures are backed by a high quality capital base," and proposed an increase (to be implemented over time) of Tier 1 capital to at least 4.5 percent of risk-weighted assets at all times for Core Tier 1 (i.e., common equity), while total Tier 1 including Additional Tier 1 capital must be at least 6 percent of risk-weighted at all times. Moreover, the new set of changes stipulated an enhancement of risk coverage of the banking institutions, and suggested continued stress tests. In addition, the reforms also raised the standard of the Pillar 2 supervisory review process and strengthened Pillar 3 disclosures requirements. Other new reforms included the introduction of a leverage ratio requirement (Tier 1 capital divided by total on and off balance sheet exposures to exceed 4 percent) to constrain banks' excessive leverage. Another important feature of the reforms is the introduction of "internationally harmonised global liquidity standard." To complement this principle, Basel III developed two minimum standards for funding liquidity. The Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ration (NSFR).

5. THE SHORT-LIVED RISE OF CONTINGENT CAPITAL INSTRUMENTS

Driven by the post-crisis capital regulatory changes, the banking industry witnessed the emergence of new asset classes mainly used to supplement a bank's funding and capital requirements. Different forms of contingent capital instruments emerged and were used by the so-called global systemically important financial institutions (G-SIFIs) to meet additional capital requirements set by the new Basel III regulation. The instruments have gained increasing support as a potential option to reduce the need for public bailouts and government support. Generally, two forms have evolved.

One is a new hybrid capital instrument in the form of fixed income securities serving as an equity buffer in time of financial stress, which are generally termed Contingent Convertible Bonds or CoCos. CoCos are designed to convert to common equity when a certain "trigger event" occurs, such as the Tier 1 ratio falling below the required level. CoCos would thus count as "going concern capital," as they become fully loss-absorbent while the bank is still solvent. The other is the bond creditor "Bail-ins," that is, a type of subordinated debt which is automatically written down to a specified percentage of face value on the occurence of a specified trigger event. Such bonds would be "going concern capital" if the trigger were set at a level such that the write-down made the bank solvent, and "gone concern capital" if they would be loss-absorbent only in the event of insolvency.

However, the use of these new contingent debt instruments had mixed levels of success. In January 2011, the International Monetary Fund produced a Staff Discussion Note debating the economic rationale and reviewed the merits and limits of contingent capital.[3]

The main conclusion of this Note can be summarised as follows:

> Contingent capital instruments are considered as part of a comprehensive and consistent crisis-management framework.
> Policies that support contingent capital should be squarely geared toward reducing the risk and cost of systemic risk.
> Contingent capital instruments could be used to meet more stringent capital buffers, increasing the additional loss-absorbing capital for the G-SIFIs.
> Contingent capital instruments are untested and need careful scrutiny in order to avoid potentially adverse effects on market dynamics.[4]

Essentially, the term *contingent convertible capital* is used very generally to describe a kind of put option enabling the issuer to issue new equity at prenegotiated terms.[5] The types, operational and regulatory impact are beyond the scope of this chapter. However, in January 2011, the Basel Committee introduced a set of new rules to supplement Basel III regulations. The supplement banned the use of all kind of contingent convertible debt instruments (CoCos) that did not meet stringent loss absorbency criteria.[6]

6. CONCLUSION

The overall goal of Basel III of promoting a more resilient banking sector remains challenged, with unresolved weaknesses in national and international financial oversight and implementation.

As always with new regulation, successful adoption requires firm and consistent application by regulators. It also requires an understanding by banks that effective regulation essentially places limits on banks' ability to maximise short term profit (if it did not, it would be ineffective) but that these limits are in the firm's own best interests.

NOTES

1. "Financial Risk Outlook: Banking Sector Digest," Financial Services Authority, UK, 2010, www.fsa.gov.uk/pages/library/corporate/outlook/fro_2010.shtml.
2. "Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems," Basel Committee on Banking Supervision, Bank for International Settlements, December 2010 (revised June 2011), www.bis.org/publ/bcbs189.htm.
   "Basel III: International Framework for Liquidity Risk Measurement, Standards, and Monitoring," Basel Committee on Banking Supervision, Bank for International Settlements, December 2010, www.bis.org/publ/bcbs188.htm.
3. "Contingent Capital: Economic Rationale and Design Features," IMF Staff Discussion Note, SDN/11/01, 2011, www.imf.org/external/pubs/ft/sdn/2011/sdn1101.pdf.
4. Ibid.
5. "Contingent Convertibles: Banks Bonds Take on a New Look," Deutsche Bank Research, May 23, 2011, www.dbresearch.com/PROD/DBR_INTERNET_EN-PROD/PROD0000000000273597.pdf.
6. "Basel Committee issues final elements of the reforms to raise the quality of regulatory capital," Press release, Bank for International Settlements (January 13, 2011), www.bis.org/press/p110113.pdf.

CHAPTER 14

Measuring Risk for Capital Adequacy: The Issue of Profit-Sharing Investment Accounts

Simon Archer and
Rifaat Ahmed Abdel Karim

1. INTRODUCTION

This chapter is concerned with the rationales for the regulation of capital adequacy and their applicability to Islamic banks. Section 2 examines the rationales for capital adequacy of conventional banks. Section 3 analyses the extent to which these rationales are applicable to Islamic banks, and examines the issues that arise in that context. Section 4 considers the links between capital adequacy and risk management in the context of the Basel Committee on Banking Supervision's (BCBS) Revised Framework (Basel Committee on Banking Supervision, 2004) and the subsequent BCBS publications on the subject in the context of what is generally known as Basel III. Section 5 sets out some concluding remarks.

2. WHY CAPITAL ADEQUACY?

All organisations that incur liabilities require some form of capital backing in order to support those liabilities—that is, for the purpose of creditor protection. In the nonprofit or government sectors, this backing may be in the form of a guarantee. For commercial firms, market forces operate so that undercapitalised firms find it hard to obtain credit. In many jurisdictions (but not, for example, in the United Kingdom), commercial firms that are

Islamic Finance: The New Regulatory Challenge.
Edited by Simon Archer and Rifaat Ahmed Abdel Karim
Copyright © 2013 by John Wiley & Sons Singapore Pte. Ltd.
ISBN: 978-1-118-62897-3

limited companies are also required by law to build up a "statutory reserve" out of retained profits for creditor protection purposes, and are subject to dividend restraints until they have done so. Also, company law typically prevents limited companies from paying dividends out of capital and out of certain reserves (such as revaluation reserves) that are not formed out of retained profits. But outside of the financial sector, the matter of capital adequacy is left essentially to market forces; in other words, undercapitalised firms encounter difficulties in obtaining credit, and so on. In fact, the term "capital adequacy" is not normally used in connection with nonfinancial firms; instead, the more general term "solvency" is used to refer to the ability to service liabilities. In contrast, capital adequacy is seen as a major issue for financial sector firms, and its use implies that the matter is not essentially left to market forces as in the case of nonfinancial firms. Why is this?

The literature on capital adequacy gives the rationales for its regulation as follows:

- Financial sector firms, and especially banks and insurance companies, are subject to various forms of regulation that impede the normal operation of market forces. In the case of banks, such regulation has as a major objective the mitigation of the systemic risk of contagious collapse, whereby one firm's failure triggers a series of others, thus imposing social costs. Banks are particularly vulnerable to contagious collapse because of the liquid nature of their liabilities combined with the illiquid nature of their assets and the magnitude of financial distress costs. But the default of an investment firm may also impose social costs, especially if it is part of a bank (in a universal banking regime) so that the bank's capital stands behind its investment operations (Dale 1996).
- Regulation may include a deposit guarantee system, which reduces incentives for depositors to impose market discipline on banks with regard to their risk taking. This leads to the deposits being underpriced in terms of their interest rates, and provides incentives for banks to hold less capital than would otherwise be required by market forces to support the risks to which they expose their depositors' funds, or alternatively to take on more deposits than is justified by their capital base (a moral hazard problem).

2.1 Basel I

For these reasons, capital adequacy has long been a preoccupation of banking supervisors. The Basel Committee on Banking Supervision (BCBS), part of the Bank for International Settlements, issued its first Capital Accord ("Basel I") in 1988. The Capital Accord was based on a two-pronged approach to capital

adequacy. The first prong was a measure of risk in terms of risk weightings applied to assets, the only risk to be considered being credit risk. The second prong was a measure of the regulatory capital available to support the risk, divided into Tier 1 and Tier 2 capital. (A Tier 3 was subsequently introduced in the 1996 Amendment to the Capital Accord to Incorporate Market Risks.) As well as equity capital, regulatory capital included amounts classified as general provisions and also (subject to limitations) subordinated debt. The latter is widely used by banks in some countries (especially the United States) where its pricing plays a role in market discipline. The ratio of regulatory capital to the amount of risk-weighted assets is the capital adequacy ratio (CAR). The aim of the 1988 Capital Accord (Basel I) was to indicate a minimum recommended level of regulatory capital, with a CAR of 8 percent.

Being intended as a minimum, this level did not aim to represent the optimum economic level of capital for a bank, capital being a residual claim that "trades off effects on liquidity creation, costs of bank [financial] distress, and the ability to force borrower repayment" (Diamond and Rajan 2000). Well-capitalised banks would tend to hold more than this minimum, especially as the Basel I Accord covered neither market risk nor operational risk. An amendment to the 1988 Accord was issued in 1996, dealing with the various forms of market risk: interest rate risk, equity position risk, foreign exchange risk, commodities (price) risk, and options. The target CAR remained at 8 percent.

During the 1990s, however, it became increasingly recognised that on the one hand the approach of Basel I to the measurement of credit risk was both over-simplistic and rigid, while on the other hand some account needed to be taken of operational risk. Moreover, the approach of banking supervisors to the regulation of capital adequacy and other matters should take account of the bank's own risk measurement and management skills (the so-called risk-based approach to supervision). With regard to credit risk, the system of risk weights called for considerable fine-tuning and elaboration to take account of various risk mitigants. Banks with the necessary capabilities should be able to use their own credit risk ratings in calculating their risk weights, rather than using the standardised weightings laid down in the Capital Accord. Other banks should be able to use credit ratings issued by approved external credit assessment institutions (ECAIs) such as Moody's, Standard & Poors, and Fitch, when available, in arriving at credit risk weightings for their financial assets.

2.2 Basel II

These considerations led to the preparation by the BCBS of a Revised Framework for capital adequacy, commonly referred to as Basel II, of which a final version was issued in June 2004, covering credit risk and operational

risk. The Basel II document is long and complex, and its preparation involved considerable controversy. In addition to capital adequacy (its first "Pillar"), the Accord deals with the principles of supervisory review (Pillar 2) and market discipline (Pillar 3). The "fine-tuning" approach adopted in Pillar 1 has been criticised on a number of grounds. One criticism is that as a result of the fine-tuning, the distinction between the regulatory capital requirement (supposedly a minimum) and a bank's economic or "optimum" level of capital is no longer clear. Another criticism is the importance given to ECAI credit ratings in the "standardised" approach, although such credit ratings are confined to a relatively small proportion of credit risks, especially from an international perspective (Cornford 2003 and 2004).

One important issue was the combining of banking with securities operations in major European banks (so-called universal banks). Different capital adequacy criteria apply to banking and securities operations. This led to the adoption of a "banking book–trading book" approach in the E.U. Capital Adequacy Directive 1993. Here, the securities activities as defined by the "trading book" are subject to a capital adequacy regime that is separate from the banking business as defined by the "banking book." One problem with this dichotomy is apparent when it is recognised that hedges of banking book items (such as hedges of foreign currency risk on financial assets) are typically handled through the bank's treasury as part of its trading activities that belong to the "trading book."

2.3 Basel III

Following the financial and economic crisis that began in 2007, the BCBS again revised its capital adequacy guidelines. The main revisions to these concerned:

- Redefining the components of regulatory capital (including some new types of convertible and subordinated capital instruments and the criteria for their being included in regulatory capital, based on their degree of loss absorbency).
- Redefining the tiers of capital; eliminating Tier 3 and distinguishing between Common Equity Tier 1, Additional Tier 1, and Tier 2. Tier 1 instruments have loss absorbency characteristics such that they absorb losses while the bank is still a "going concern," while Tier 2 instruments absorb losses when the bank is in liquidation—hence the term "gone concern capital."
- Increasing the requirement for common equity, including a "capital conservation buffer," to a total of 6 percent.

- Introducing a "countercyclical capital buffer" for the macroprudential purpose of mitigating both credit bubbles in times of economic expansion and credit crunches in times of contraction.
- Introducing a "leverage ratio'"—a minimum percentage of Tier 1 capital to total unweighted exposures—intended to prevent low risk weightings of assets allowing banks to take on excessive levels of assets in relation to capital.

For reasons that will be explained below, the leverage ratio just mentioned has relevance for Islamic banks, although as a matter of principle they have no interest-bearing liabilities.

3. APPLICATION TO ISLAMIC BANKS

Typically, Islamic banks are somewhat similar to universal banks, in that they combine banking operations with trading operations, not necessarily in securities but in commodities and other nonfinancial assets—for example, by means of *salam* and *istisna'a* contracts. However, they differ significantly in that they typically mobilise funds in the form, not of interest-bearing deposits, but of profit-sharing investment accounts (PSIA). This is relevant to the specification of the CAR: Are PSIA part of the bank's risk-bearing capital (numerator of the CAR), and are the assets financed by PSIA part of the bank's assets that, on a risk-weighted basis, are included in the denominator of the CAR? This issue is discussed further in Subsections 3.1–3.3.

The calculation of risk-weighted assets is also affected by two factors:

1. The risk characteristics of Islamic banks' assets differ in a number of cases from those of conventional banks, either: (a) because of their juristic (*Shari'ah*) attributes as financial assets; or (b) because they are not financial assets but real estate, commodities, or work-in-process inventories (in the cases of *ijarah*, *salam*, or *istisna'a* assets, respectively); or (c) because they result from financing made on a profit-sharing basis and are exposed to losses which do not constitute contractual defaults (for asset-side *mudarabah* and *musharakah*).
2. Risk mitigation is affected by *Shari'ah* restrictions, such as those on guarantees and on the use of derivatives.

These are technical, rather than conceptual, issues that are dealt with in the Explanatory Note which is part of the IFSB Standard No. 2 on Capital Adequacy,[1] and will not be explored further here, except for asset-side *mudarabah* and *musharakah*, which are discussed in Subsection 3.5 below.

There are other, systemic, sources of difference that affect liquidity risk. These sources include the lack, in many countries, of *Shari'ah*-compliant cash equivalents that offer a return to the holder, of a *Shari'ah*-compliant interbank market, and of a *Shari'ah*-compliant lender of last resort facility. The effect of this on capital adequacy is a matter for Pillar 2 of the Revised Framework, and will be discussed in Section 4.

On a more fundamental level, one may ask to what extent Islamic banks share those characteristics of conventional banks mentioned above, which raises two questions: the first regarding capital adequacy, and the second about whether they have other, different, characteristics with capital adequacy implications:

1. Are Islamic banks exposed to, and do they contribute to, the systemic risk of contagious collapse?
2. To what extent do PSIA share the moral hazard implications of deposits that are due to the effects of deposit guarantee schemes?

3.1 Islamic Banks, Financial Distress, and Systemic Risk

Because PSIA juristically are not debt claims (except in cases of misconduct or negligence by the bank), but a form of limited-term equity or residual claim, shocks to asset values for assets financed by PSIA are passed on to the PSIA holders and thus do not impact the bank's own capital. However, Islamic banks are not immune from "runs" in the sense of large volumes of "panic" withdrawals of PSIA funds, which might follow such shocks and could result in financial distress to an Islamic bank in the form of a liquidity crisis. As Dale (1996, 8) points out, a conventional investment firm faced by such problems "will generally be able to wind down its business in an orderly manner, meeting its obligations through prompt asset disposals at close to book value," since its assets "consist mainly of marketable securities and there will be little difference between [their] value on a going concern basis and in liquidation." However, Islamic banks tend to invest PSIA funds in assets that are relatively illiquid, such as *murabahah*, *ijarah*, and *salam*. PSIA holders typically have the right to withdraw their funds at short notice subject to forfeiting their share of profit (but not of loss) for the most recent period. Moreover, the investment activities of Islamic banks are conducted under the same corporate umbrella as their banking activities. Also, in the case of unrestricted PSIA, the funds are typically commingled with the bank's own funds. Hence, losses on asset disposals may impact the bank's own capital as well as that of the PSIA. (This would not be the case for restricted PSIA funds, unless the bank had invested its own funds in the same asset pool.) PSIA holders who

insist on withdrawing their funds must therefore suffer any resultant losses on asset disposals.

Hence, Islamic banks are not immune to systemic risk, but as described above it manifests itself primarily as liquidity risk. The exposure of the bank's own capital is limited to the effects of forced asset disposals on assets financed on a commingled basis, which should not normally be significant enough to imply a need for the regulation of capital adequacy. However, there may be factors owing to which the juristic nature of PSIA as a form of limited-term equity investment may be overlaid by economic characteristics closer to those of conventional deposits. These are discussed in Subsection 3.4.

In addition, Islamic banks are increasingly using a form of term deposit based on reverse commodity *murabahah* transactions (CMT) in place of unrestricted PSIA. This is especially true of Islamic investment banks, but is also the case in the "universal" form of Islamic bank with retail operations. As CMT-based deposits have none of the loss-absorbent attributes of PSIA, their use as a source of funds can make Islamic banks more vulnerable to financial distress, because of the "refinancing" risk of being unable to roll over such deposits in stressed credit conditions. (This is why the leverage ratio mentioned above may be relevant to Islamic banks.)

3.2 Market Failure

The rationale for capital adequacy regulation of conventional banks depends partly on the social costs of contagious failure (systemic risk) and partly on the failure of market discipline owing to deposit guarantee schemes (as discussed in Subsection 3.3). However, in the environments in which Islamic banks typically operate, there may be a more general lack of market discipline. This is suggested by recent research carried out by Ariffin (2005) (see also Archer and Karim 2006), and would provide an additional reason for capital adequacy regulation of Islamic banks.

3.3 Displaced Commercial Risk

The above reasoning is based on the juristic nature of PSIA as profit sharing and loss bearing. However, this characterisation requires some qualification, for three reasons:

1. Unrestricted PSIA holders may be more risk-averse than Islamic bank shareholders, but the funds of the two categories of investor are typically commingled. Unrestricted PSIA holders seek a safe investment vehicle for their liquid funds and savings, comparable to conventional deposit accounts. This raises the issue of what level of risk profile an

Islamic bank would adopt in selecting the assets to be financed by commingled funds.

2. This has led to Islamic banks practicing the smoothing of investment returns to PSIA, using a combination of reserve accounts (profit equalisation reserve and investment risk reserve [Accounting and Auditing Organization for Islamic Financial Institutions, or AAOIFI 1999a]) and, if necessary, the forfeiting of part or all of the bank's *mudarib* share of profit for a given year. This practice gives rise to displaced commercial risk (AAOIFI 1999b).
3. Some banking supervisors have taken the view that this practice results in a modification of the legal attributes of the PSIA, such that the Islamic banks have a constructive obligation to continue the practice. In other words, instead of being voluntary, the practice becomes obligatory, unrestricted PSIA being regarded as virtually "capital certain," so that Islamic banks are severely restricted in their ability to pass losses on to unrestricted PSIA holders. Displaced commercial risk thus assumes an institutional character, with implications for capital adequacy.

The above considerations led the Islamic Financial Services Board (IFSB), in its Capital Adequacy Standard, to set out two alternative versions of the CAR for Islamic banks. In the first version, the credit and market risks of assets financed by PSIA are treated as being borne entirely by the PSIA holders. In the second version, a proportion α (alpha) of the risk-weighted assets financed by *unrestricted* PSIA is included in the denominator of the CAR, which has the effect of requiring the Islamic bank to hold regulatory capital against the credit and market risks of that proportion of those assets. It is up to the national banking supervisor to determine the proportion α for each Islamic bank in its jurisdiction.

In addition, recent research by IFSB (2004) has shown that in some countries PSIA are covered by deposit guarantee schemes, even though this is not *Shari'ah*-compliant unless the scheme operates on the basis of *takaful* or is provided by the central bank free of charge. In such an environment, PSIA share (at least to some extent) those characteristics of conventional deposits that give rise to moral hazard and the consequent need for the regulation of capital adequacy.

3.4 Islamic Bank Capital and the Economic Characteristics of PSIA

The above discussion indicates that the economic characteristics of PSIA are complex and may vary between jurisdictions. In no cases are PSIA part of the bank's capital, but juristically they should be available to absorb all losses resulting from credit or market risk exposures in respect of the assets that

they finance, in the absence of misconduct or negligence by the bank. In practice, however, PSIA may be partially assimilated to conventional deposits, with implications for the bank's own capital (displaced commercial risk), and may even be covered by deposit guarantee schemes. In such cases, as indicated in Subsection 3.3 above, there are implications for the Islamic bank's capital adequacy that need to be taken into account by including some proportion of the assets financed by PSIA, on a risk-weighted basis, in the denominator of the CAR.

Do PSIA give rise to moral hazard problems similar to those associated with conventional deposits? Certainly, as Al-Deehani, Karim, and Murinde (1999) point out, Islamic banks have incentives to maximise the amount of PSIA that they control. Because PSIA are not liabilities, there is in principle no hard financial constraint on the volume of PSIA funds taken on by a bank; the bank benefits from the *mudarib* share of profits on managed funds, while incurring only the payroll and associated costs of providing asset management. The constraint is thus a soft constraint of managerial capacity to provide effective asset management, in a context where economies of scale are significant. It is not clear that Islamic banks have any incentive to take on amounts of PSIA funds in excess of what they can effectively manage. However, there could be a problem of incentive misalignment insofar as the unrestricted PSIA holders are likely to be more risk-averse than the bank's shareholders. This leads to a type of moral hazard problem that is associated with displaced commercial risk. Hence, in environments where displaced commercial risk is a significant factor, the volume of unrestricted PSIA has capital adequacy implications, as discussed earlier.

3.5 Risk Weights for Profit-Sharing Assets

Islamic financing assets that are profit-and-loss sharing (*musharakah* financing) or are profit sharing and loss bearing (*mudarabah* financing) are not easily accommodated within the credit risk methodology of the Basel Accords, and therefore called for particular attention from the IFSB in its Capital Adequacy Standard. Where the *musharakah* or *mudarabah* assets are commodities or other assets that are held for trading, the risk involved is essentially the market risk of those assets, and there is no particular problem of credit risk.

However, when the *mudarabah* or *musharakah* is used as a means of financing and the assets are intended to be held to maturity, the risk is essentially a credit risk—namely, a risk of capital impairment. The provisions of Basel II (Pillar 2) include a category of credit risk referred to as "equity position risk not in the trading book"—that is, in the "banking book." This category is primarily intended to cater for shares held by banks as long-term

investments in companies with which they have a lending relationship, which is a familiar feature of "relationship banking" in some continental European countries. Such shares may or may not be listed on a recognised stock exchange. However, some types of *musharakah* investment, typically those in a business venture, combine the risk of an equity position (normally unlisted) with a "banking book" intention to hold the investment to maturity. Hence, the IFSB Standard proposes a risk weighting for such assets that is similar to that set out in Basel II for equity position risk exposures in the banking book. Alternatively, some *musharakah* and *mudarabah* investments, especially diminishing *musharakah*, could be seen as a category of "specialised lending" (or, more precisely, specialised financing) for which Basel II provides "supervisory slotting criteria" for arriving at risk weightings. The IFSB Standard allows the use of risk weights based on such criteria as an alternative to those resulting from treatment of such assets as equity positions in the banking book.

The credit risk weightings resulting from the approaches just outlined are high compared to those on other financing assets such as *murabahah* or *ijarah muntahia bittamleek*, and, in the case of "equity position risk in the banking book" very high, in the absence of risk mitigation. This emphasises the importance of financing structures in such cases that serve to mitigate credit risk. This has implications for banking supervisors, as mentioned in Section 4.

4. PILLAR 2 OF THE REVISED FRAMEWORK AND RISK MANAGEMENT

Pillar 2 of Basel II is concerned with the supervisory review process, which "is intended not only to ensure that banks have adequate capital to support all the risks in their business, but also to encourage banks to develop and use better risk management techniques in monitoring and managing their assets . . . Supervisors are expected to evaluate how well banks are assessing their capital needs relative to their risks and to intervene, where appropriate" (Basel Committee on Banking Supervision, 2004: paragraphs 720 and 722). The following risks are mentioned specifically in the order given below (Basel Committee on Banking Supervision, 2004: paragraphs 733–742), but this list is not intended to be exhaustive.

- Credit risk.
- Operational risk.
- Market risk.
- Interest rate risk in the banking book.
- Liquidity risk.
- Other risks, such as reputational and strategic risk.

From the perspective of Islamic banks, the following call for comment in this section: credit risk; an analogue of interest rate risk in the banking book (namely, displaced commercial risk); and liquidity risk, an increase in which may be one of its consequences.

4.1 Credit Risk

Apart from Islamic banks' credit risk methodologies and systems in general, the analysis in Subsection 3.5 above indicated a particular need for supervisory attention to the measurement and management of credit risk arising from profit-sharing and loss-bearing assets. Among other matters, supervisors will need to decide which of the two risk measurement methodologies is more appropriate: the market-based approach for equity exposures in the banking book with its high-risk weights; or the supervisory slotting criteria approach for specialised lending with its lower risk weights. In principle, the latter approach should be authorised only when the supervisor is confident that the slotting criteria are appropriate for the credit risk exposures and will be correctly applied.

4.2 Displaced Commercial Risk

In conventional banking, interest rate risk in the banking book results from mismatches between assets and liabilities, as a result of which the rate payable on liabilities exceeds that receivable on assets, thus subjecting the bank to an "interest rate squeeze" that may threaten its viability. For Islamic banks, while there is no interest payable or receivable, there are returns receivable of a mark-up nature (for example, on *murabahah* assets) or *ijarah* rentals that are fixed in advance, while the returns expected by PSIA holders (especially for unrestricted PSIA) follow current market expectations. The result is a similar kind of squeeze that leads to displaced commercial risk. The severity of this squeeze and its implications for capital adequacy will depend, among other things, on the economic characteristics of unrestricted PSIA in the country concerned, as discussed in Section 3 above. This matter therefore calls for particular attention from supervisors under Pillar 2. Supervisors need to evaluate the risk management systems of Islamic banks in their jurisdiction, and their exposure to and capability to manage displaced commercial risk.

4.3 Liquidity Risk

When Islamic banks are not considered to have a constructive obligation to maintain the capital of unrestricted PSIA, they may nevertheless face

considerable commercial pressure and resultant risk of the withdrawal of PSIA funds—that is, liquidity risk. For systemic reasons mentioned in Section 3 above, liquidity risk tends in any case to be a particular problem for Islamic banks. Supervisors will need to pay particular attention to the issue of whether Islamic banks in their jurisdiction have "adequate systems for measuring, monitoring and controlling liquidity risk . . . [and for evaluating] the adequacy of capital given their liquidity profile and the liquidity of the markets in which they operate" (Basel Committee on Banking Supervision, 2004: paragraph 741). It should also be noted that the BCBS, in Basel III, has given considerable emphasis to the management of liquidity risk, and the IFSB has issued a standard *Guiding Principles on Liquidity Risk Management for Institutions Offering Islamic Financial Services* (March 2012).

The IFSB also spearheaded the establishment of the International Islamic Liquidity Management Corporation (IILM) in October 2010 whose main objective is to issue high-quality financial instruments that assist Islamic banks and financial institutions in managing their liquidity.

5. CONCLUDING REMARKS

This chapter has reviewed some salient issues in the matter of regulating the capital adequacy of Islamic banks, against the conceptual background of capital adequacy regulation of banks in general. The justification for capital adequacy regulation in the case of conventional banks lies partly in the social costs of contagious collapse (systemic risk), and partly in the lack of market discipline whereby, if fully effective, inadequately capitalised banks would be obliged by market forces to obtain adequate capital or to curtail their activities. A major reason for this lack of market discipline is the existence of deposit guarantee schemes that reduce market incentives to monitor banks.

The analysis above indicated that both the social costs and the market failure rationales apply to Islamic banks, but with some differences as compared to conventional banks. With regard to the social costs rationale, in principle PSIA impose requirements for liquidity rather than capital adequacy. However, a major issue for international guidelines on capital adequacy is the variations between countries in the economic characteristics of unrestricted PSIA. In some countries, they are considered to impose constructive obligations on Islamic banks comparable to those imposed by conventional deposits; in other countries they impose commercial constraints that have a similar effect. In such countries, unrestricted PSIA may account

for a large proportion of the funds mobilised by Islamic banks. This leads to the problem of displaced commercial risk in such countries. In other countries, the treatment of unrestricted PSIA is more in accord with their juristic nature in the *Shari'ah*, while in yet other countries Islamic banks avoid offering unrestricted PSIA at all. Hence, international capital adequacy guidelines must leave scope for national bank supervisors to apply a capital adequacy regime in respect of unrestricted PSIA that fits their economic characteristics in the local environment. In addition, it was noted that there is a trend among Islamic banks to use CMT-based term deposits in place of unrestricted PSIA, which may increase their vulnerability to financial distress.

With regard to the market failure rationale, research indicates that market discipline tends to be weak in the countries in which Islamic banks operate. Also, in some countries, unrestricted PSIA are covered by deposit guarantee schemes. For these reasons, capital adequacy cannot be left to market forces, but requires the intervention of the banking supervisor.

Thus, the rationales for the regulation of capital adequacy for conventional banks are applicable to Islamic banks. Technical rather than conceptual differences exist in the identification, measurement, and mitigation of credit risk and market risk. In the case of asset-side *musharakah* and *mudarabah*, the differences are more of a conceptual nature, as such profit-sharing and loss-bearing investments are not normally found in the "banking book" of conventional banks, and if they do exist they receive a very high risk weighting under Basel II. Under appropriate circumstances, and at the supervisor's discretion, they may, however, be considered under the "specialised lending" provisions of Basel II which involve less onerous risk weightings. Nevertheless, a major conceptual difference (and problem) concerns the economic characteristics of unrestricted PSIA, which vary from their being regarded as virtual deposits (that is, not loss-bearing, and entitled to a fairly predictable return) in some countries, to their being considered in other countries as essentially a form of limited-term equity investment (a position more in line with their juristic nature in accordance with *Shari'ah* principles). These differences have substantial implications for capital adequacy and for the calculation of the CAR.

NOTE

1. At the time of writing, the IFSB has issued an Exposure Draft of a revised Capital Adequacy Standard in the light of implications of the financial and economic crisis that began in 2007 and of Basel III.

REFERENCES

Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). 1999a. Financial Accounting Standard No. 11: Provisions and Reserves.

Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). 1999b. "Statement on the Purpose and Calculation of the Capital Adequacy Ratio for Islamic Banks." Bahrain: Accounting and Auditing Organisation for Islamic Financial Institutions.

Al-Deehani, T., R.A.A. Karim, and V. Murinde. 1999. "The Capital Structure of Islamic Banks Under the Contractual Obligation of Profit Sharing." *International Journal of Theoretical and Applied Finance*, 2 (3): 243–283.

Archer, S. and R.A.A. Karim. 2006. "Corporate Governance, Market Discipline and Regulation of Islamic Banks." *The Company Lawyer*, 27 (5): 134–145.

Ariffin, N. 2005. "Enhancing Transparency of Islamic Banks: Risk Reporting Issues." Unpublished PhD thesis, University of Surrey.

Basel Committee on Banking Supervision (BCBS). 2004. *International Convergence of Capital Measurement and Capital Standards: A Revised Framework*. Basel: Bank for International Settlements,.

Basel Committee on Banking Supervision (BCSB). 2011. Basel III: *A Global Regulatory framework for More Resilient Banking, Banks, and Banking Systems*. Basel: Bank for International Settlements.

Cornford, A. 2003. "A Review of Comments of Developing Countries on the April 2003 Consultative Documents of the Basel Committee on Banking Supervision, the New Basel Capital Accord." Working Paper, Financial Markets Center.

Cornford, A. 2004. "Basel II: The Revised Framework of June 2004." Working Paper, Financial Markets Center.

Dale, R. 1996. *Risk and Regulation in Global Securities Markets*. Chichester, UK: John Wiley & Sons.

Diamond, D. and R. Rajan. 2000. "A Theory of Bank Capital." *Journal of Finance*, LV (6).

Islamic Financial Services Board (IFSB). 2004. "Corporate Governance Working Group: Report on Survey of Corporate Governance of Institutions Offering Islamic Financial Services." Kuala Lumpur: IFSB.

Islamic Financial Services Board (IFSB). 2012. "Guiding Principles on Liquidity Risk Management for Institutions Offering Islamic Financial Services." Kuala Lumpur: IFSB.

CHAPTER 15

Measuring Operational Risk

Sandeep Srivastava and
Anand Balasubramanian

1. INTRODUCTION

Operational risk remained a fuzzy concept for a long time in the banking industry because it was hard to make a clear-cut distinction between operational risk and the "normal" uncertainties faced by the banks in their daily operations. Although everyone agreed that there was a risk other than the popularly known credit, market, and liquidity risks faced by a bank, the catastrophic nature of operational risk came into limelight in the wake of the huge losses incurred by Barings Bank and Daiwa Bank in the mid-1990s. The classical story of misclassification of operational risk continued for quite some time in the industry, with some of the operational risks getting misclassified as other risks. For example, no distinction was made in the losses caused by the deterioration in credit quality of the borrower and losses emanating from the fact that the credit officer did not correctly apply the credit policy. It was not uncommon to see both these losses getting lumped together under credit risk while it is quite clear that the losses in the latter case should be attributed to operational risk.

The Basel Committee for Banking Supervision (BCBS) defined operational risk as "the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk,[1] but it excludes strategic and reputational risk."[2] As per the Basel II Accord, banks are required to hold capital against operational

Islamic Finance: The New Regulatory Challenge.
Edited by Simon Archer and Rifaat Ahmed Abdel Karim
Copyright © 2013 by John Wiley & Sons Singapore Pte. Ltd.
ISBN: 978-1-118-62897-3

risk, in addition to the credit and market risks, under Pillar 1. This development opened up a whole new paradigm in which banks started focusing on the measurement of operational risk using quantitative techniques.[3] The Accord allows banks to choose from a buffet of options[4] ranging from simple (basic indicator approach, BIA) to intermediate (standardised approach) to advance approaches (advanced measurement approaches, AMA).[5] The ultimate objective is to ensure that a bank that is exposed to high operational risks maintains more capital for operational risk.

The overall expectation of the Basel Committee with regard to managing operational risks is summarised in the following extract.

> *Irrespective of the risk management and risk measurement practices adopted, a bank's operational risk strategy should reflect the nature and source of the bank's operational risks for all Operational Risk Measurement System (ORMS) elements, including regular review of predictive elements against experience. The operational risk strategy should be current and reflect material changes to the internal and external environment. Risk reporting should provide a clear understanding of the key operational risks, the related drivers and the effectiveness of the internal controls. The internal reporting framework should include regular reporting of relevant information at all levels of the bank, be transparent, responsive to changes, appropriate and support the proactive management of operational risk.*[6]

Operational risk measurement is an important component of the operational risk strategy and framework. A sound operational risk measurement approach brings transparency into the operational risk management process. There are a host of approaches; some are less quantitative while the others are more quantitative, for the measurement of operational risk. This chapter covers the subject of operational risk measurement both from a practitioner's perspective and Basel requirements. The rest of this chapter is divided into four sections: operational risk in the context of Islamic banks; operational risk capital calculation under Basel II; operational risk under the Islamic Financial Services Board (IFSB) standard; and implementation issues. Some details relating to Basel II requirements are contained in the appendices.

2. OPERATIONAL RISK IN THE CONTEXT OF ISLAMIC BANKS

On the question of whether Islamic banks are subject to different types of operational risks, the answer is "yes" and "no." There are some operational risks common to both Islamic and conventional banks. For example, the

risks of failed internal processes, fraud, improper business or market practices, theft, hacking, and so forth are the common risks faced by both Islamic and conventional banks. In addition, there are some risks which are unique to Islamic banks, such as:

1. Risk of *Shari'ah*–non-compliance that arises from the bank's failure to comply with the *Shari'ah* rules and principles determined by its *Shari'ah* board or the relevant body in the jurisdiction in which the Islamic bank operates. Inability of a bank to manage this risk properly may have disastrous consequences, with deposit holders withdrawing their funds or cancellation of contracts with the borrowers and counterparties. In addition, this risk is deemed to be significant in the absence of uniformity of *Shari'ah* interpretation. It is not uncommon to see different *Shari'ah* interpretations by different *Shari'ah* scholars.
2. Fiduciary risk that arises due to the bank's failure to perform in accordance with some explicit and implicit standards to safeguard the interest of investment accountholders.
3. Risks arising out of the complex documentation involved in Islamic products.

Does this mean that Islamic banks will have different methodologies for measuring operational risk? The answer is "no." Merely having some unique operational risks does not necessitate new risk measurement methodologies. For example, risks arising from non-compliance with the internal policy and non-compliance with the *Shari'ah* requirements can be measured using the same methodology, although the likelihood and severity of losses in these cases could be very different. The difference may also be there in terms of the availability of loss history, because the bank may not have enough data for the losses caused by the non-compliance with *Shari'ah* requirements or it may not have classified the losses in the right category.

3. OPERATIONAL RISK CAPITAL UNDER BASEL II

The Basel II Accord prescribes three methods for calculating operational risk capital charges in a continuum of increasing sophistication and risk sensitivity. These three approaches are:

1. Basic indicator approach (BIA).
2. The standardised approach (TSA) [including alternative standardised approach (ASA)].
3. Advanced measurement approaches (AMA).

Banks can start with the simple approach, like BIA or TSA, and are expected to migrate to the more advanced approaches over a period of time once they have sufficient infrastructure in place with regard to the data and measurement methodologies. The key idea is that a bank should hold operational risk capital in proportion to the amount of operational risk involved in its activities. BIA and TSA are purely based on gross income as the basis for calculating operational risk capital, while AMA allows banks to develop their own models to calculate the amount of operational risk capital. However, in case of AMA, banks will have to prove the applicability and appropriateness of their models to the regulator. Therefore, banks will be allowed to migrate to the advanced approaches subject to regulatory approval. In addition, banks are required to follow the Principles for the Sound Management of Operational Risk issued by Basel Committee in June 2011.[7]

Exhibit 15.1 shows the brief summary of different methods prescribed under Basel II Accord for operational risk capital.

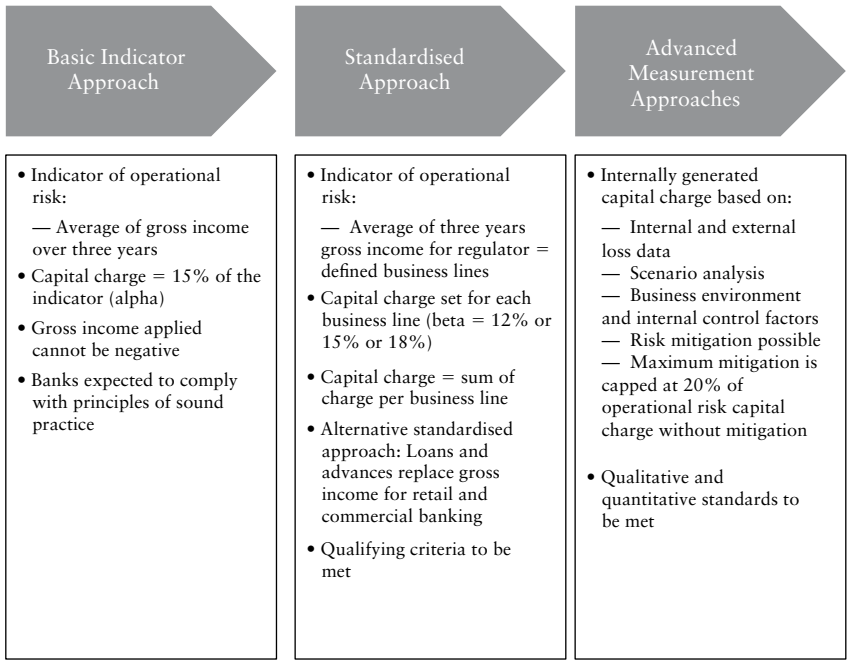

Basic Indicator Approach
Standardised Approach
Advanced Measurement Approaches
• Indicator of operational risk:
— Average of gross income over three years
• Capital charge = 15% of the indicator (alpha)
• Gross income applied cannot be negative
• Banks expected to comply with principles of sound practice
• Indicator of operational risk:
— Average of three years gross income for regulator = defined business lines
• Capital charge set for each business line (beta = 12% or 15% or 18%)
• Capital charge = sum of charge per business line
• Alternative standardised approach: Loans and advances replace gross income for retail and commercial banking
• Qualifying criteria to be met
• Internally generated capital charge based on:
— Internal and external loss data
— Scenario analysis
— Business environment and internal control factors
— Risk mitigation possible
— Maximum mitigation is capped at 20% of operational risk capital charge without mitigation
• Qualitative and quantitative standards to be met

EXHIBIT 15.1 Approaches under Basel II for Operational Risk Capital Calculation

3.1 Basic Indicator Approach

Under the BIA, banks must hold capital equal to the average over the previous three years of a fixed percentage (denoted alpha) of positive annual gross income for operational risk. Figures for any year in which annual gross income is negative or zero should be excluded from both the numerator and denominator when calculating the average. The capital calculation, under BIA, can be expressed as follows:

$$K_{BIA} = \left[\sum (GI_{1.n}\alpha)\right]/n$$

Where: K_{BIA} = the capital charge under BIA
GI = annual gross income, where positive, over the previous three years
n = number of the previous three years for which gross income is positive
α = 15% (as determined by the local regulator)

3.2 The Standardised Approach (Including Alternative Standardised Approach)

TSA is very similar to BIA, except that bank's activities are divided into eight different business lines. Under TSA, capital is calculated as the average over the previous three years of a fixed percentage (denoted beta) of positive annual gross income for each of the business lines. Each business line is assigned a single multiplier (beta, or capital factor β), which serves as a proxy for the industry-wide relationship between the operational losses experienced and the gross income of a particular business line. Beta ranges from 12 percent to 18 percent (as shown in Exhibit 15.2) that indicates relative risk characteristics of the underlying business line.

The capital charge is expressed as follows:

$$K_{TSA} = \left[\sum_{\text{years } 1-3} \max[GI_{1-8} \times \beta_{1-8}, 0]\right]/3$$

Where: K_{TSA} = the capital charge under TSA
GI_{1-8} = annual gross income in a given year, as defined above in the BIA, for each of the eight business lines
β_{1-8} = a fixed percentage, relating to the level of the gross income for each of the eight business lines.

EXHIBIT 15.2 Beta Factors for Different Business Lines

Business Lines	Beta Factors
Corporate finance	18%
Trading and sales	18%
Retail banking	12%
Commercial banking	15%
Payment and settlement	18%
Agency services	15%
Asset management	12%
Retail brokerage	12%

Banks will need to compute the capital requirement for each of the business lines for the past three years as the product of the corresponding beta factor and gross income. The total capital requirement is calculated as the three-year average of the simple summation of the regulatory capital charges across each of the business lines in each of the three years. In any given year, negative capital charges (resulting from negative gross income) in any business line may offset positive capital charges in other business lines without limit. Input to the numerator is taken as zero for the year in which aggregate capital charge across all business lines is negative.

In case an activity cannot be clearly mapped into the eight business lines, it can be mapped to the business line that most closely approximates such an activity. However, this mapping should remain consistent over a period of time and cannot be changed without the explicit approval of the regulator.

ASA is simply an adaptation of TSA wherein the exposure amount is used as the basis for the calculation of operational risk capital for two business lines, namely retail banking and commercial banking, as opposed to gross income. For these business lines, loans and advances—multiplied by a fixed factor m—replace gross income as the exposure indicator. The betas for retail and commercial banking remain same as in TSA. The ASA operational risk capital charge for retail banking (with the same basic formula for commercial banking) can be expressed as:

$$K_{RB} = \beta_{RB} \times m \times LA_{RB}$$

Where: K_{RB} is the capital charge for the retail banking business line.
β_{RB} is the beta for the retail banking business line.
LA_{RB} is total outstanding retail loans and advances (non-risk-weighted and gross of provisions), averaged over the past three years.
m is 0.035.

3.3 Advanced Measurement Approaches

Under AMA the banks are allowed to develop their own empirical model to compute required capital for operational risk. Banks can use this approach only subject to approval from their local regulators. An AMA framework must include the use of four data elements, namely internal loss data, external data, scenario analysis, and business environment and internal control factors. This is supplemented by the data and information generated out of risk and control self-assessment and key risk indicators. The schematic of capital calculation under AMA is shown as Exhibit 15.3. AMA requires that the bank's business lines be mapped onto the eight business lines as explained under TSA, and seven event types specified by Basel,[8] and expected and unexpected losses are calculated for each of those subcategories, as applicable.

While AMA does not specify the use of any particular modeling technique, one common approach taken in the banking industry is the loss distribution approach (LDA). With LDA, a bank first segments operational losses into homogeneous segments, such as an event type for a business line. For each such unit (event type for a business line), the bank then constructs a

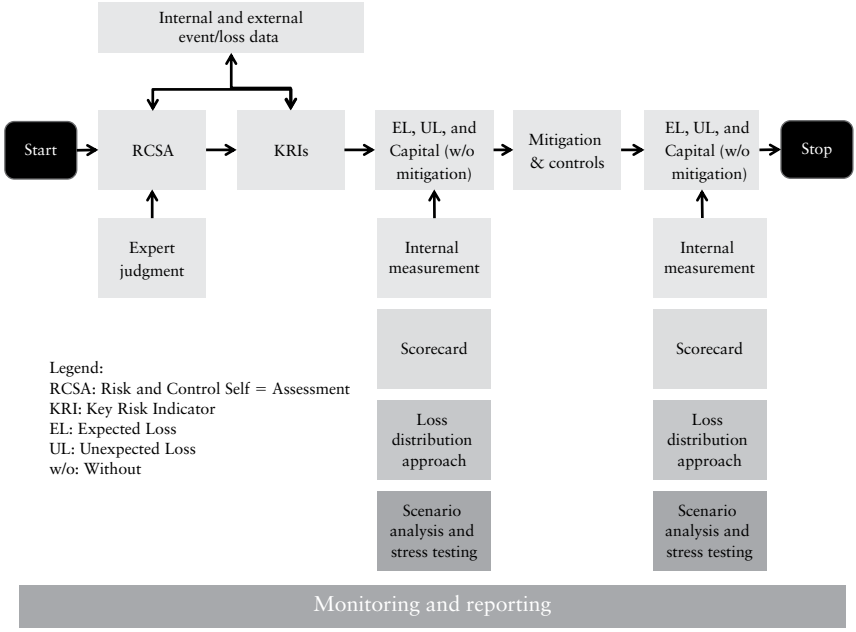


EXHIBIT 15.3 Schematic Showing the Capital Calculation under AMA

loss distribution that represents its expectation of total losses that can materialise over a one-year horizon. Given that data availability is a major challenge for the industry, an annual loss distribution cannot be built directly using annual loss figures. Instead, a bank will typically develop a frequency distribution that describes the number of loss events in a given year and a severity distribution that describes the loss amount of a single loss event. The convolution[9] of these two distributions then gives rise to the (annual) loss distribution.

In addition, banks are required to follow a set of eight qualitative requirements for the approval of AMA. These are aimed at ensuring that there are a proper governance structure and controls around the process of internal model development and implementation:

1. Existence of an independent operational risk management function.
2. Policies and procedures for a sound operational risk management system and measurement methodology.
3. Design and implementation of a risk-reporting system for operational risk.
4. Strategies to identify, measure, monitor, and control/mitigate operational risk.
5. Outputs from internal ORM system to be integrated into the process of monitoring and controlling the bank's operational risk profile.
6. Techniques for allocating operational risk capital to major business lines and for creating incentives to improve the management of operational risk throughout the firm.
7. Adequate/competent resources to design and implement the ORM framework.
8. ORM system to be documented, and processes to ensure compliance and treatment of noncompliant issues.

Banks having a robust control environment and managing their operational risks properly are expected to save significant capital by migrating to AMA. Once a bank has been approved to adopt AMA, it cannot revert to a simpler approach without supervisory approval.

3.4 An Intuitive View of Different Approaches under Basel II Accord

Having examined the different approaches prescribed under Basel II, it is important to analyse the underlying logic that links each of these approaches. The most sophisticated approach under Basel II is AMA as described previously. It requires the banks to compute expected losses and unexpected

losses for each event type and business line. There are seven event types and eight business lines that result in a matrix of 56 cells, as shown in Exhibit 15.4. This means that banks are required to have a loss database[10] for 56 different combinations of business lines and event types, although more sophisticated banks may add more categories to this matrix. Similarly, some of the cells may not be relevant for some banks, in which case they will not be computing expected losses and unexpected losses for them. Once these cells are populated, banks will then simply calculate the grand total of all the cells, taking into account the correlation among different cells for unexpected losses, which represents the amount of operational risk capital required for a bank.[11] A simple summation would correspond to the assumption that the correlation is "1," that is, "all bad things will happen at the same time."

Moving towards less sophisticated approaches, like TSA or BIA, means that the granularity of data requirements will be reduced and proxies are used for operational loss distributions. For example, moving from AMA to TSA shows that operational risk capital is required for eight business lines only and no separate assessment is required for event types (i.e., all events are collapsed into a single event). That is why the capital is calculated for eight cells only under TSA. In addition, given the anticipated data constraints faced by banks, the Basel Committee has provided gross income and beta factors as the basis to calculate operational risk capital instead of expected and unexpected losses, as applicable to AMA. Therefore, moving from AMA to TSA results in less granularity (in terms of the operational risk capital calculation) as well as the use of proxies like gross income and beta factors instead of loss distributions.

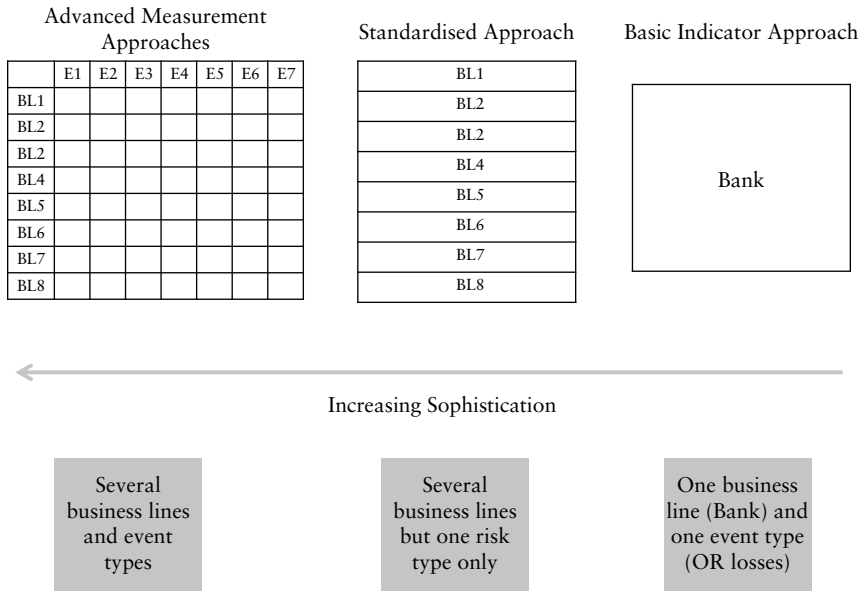
Similarly, moving backwards from TSA to BIA results in a further reduction in granularity (i.e., only one number is calculated for operational risk capital for the entire bank and the proxy remains the same, i.e., gross income).

To summarise, the hierarchy of approaches prescribed under Basel II Accord are simply based on the two main elements as depicted in Exhibit 15.5:

1. Granularity in terms of business lines and event types—as we move towards more sophisticated approaches, BIA to TSA to AMA, more granularity is required in terms of business lines and event types, that is, from one cell in BIA to eight cells in TSA to 56 cells in AMA.
2. Use of proxies—gross income along with alpha factor (under BIA) and beta factor (under TSA) are used as proxies for operational loss distribution. While, in AMA, the actual loss history or proxy data (scenario-based or external data) for loss history is used for the purpose of operational risk capital calculation.

EXHIBIT 15.4 Business Lines and Event Types for AMA

Business Lines	Loss Event Types							
	Internal Fraud	External Fraud	Workplace Safety	Clients, Products, and Business Services	Damage to Physical Assets	Business Disruption and System Failure	Execution, Delivery, and Process Management	Total
Corporate Finance								
Trading and Sales								
Retail Banking								
Commercial Banking								
Payment and Settlement								
Agency and Custody Services								
Asset Management								
Retail Brokerage								
Total Across Business Lines								



Legend-BL: Business Lines; E: Event Type

EXHIBIT 15.5 An intuitive view of different approaches under Basel II

4. OPERATIONAL RISK CAPITAL UNDER THE IFSB STANDARD

As per the Capital Adequacy Standards issued by the IFSB in December 2005, Islamic banks are required to follow the BIA or TSA (subject to the approval of the local regulator). The alpha factor is 15 percent for BIA (same as Basel II Accord). However, the gross income is calculated as[12]:

1. Net income from financing activities, which is gross of any provisions and operating expenses, and of depreciation of ijarah assets.
2. Net income from investment activities.
3. Fee income (such as commission and agency fee).

Less:

4. Investment account holders' share of income.

The gross income includes income attributable to restricted and unrestricted profit-sharing investment accounts' funds, but excludes extraordinary or exceptional income. Net income from investment activities includes

the bank's share of profit from *musharakah* and *mudarabah* financing activities.

Islamic banks are required to follow the BIA. For Islamic banks looking forward to adopting TSA, the determination of beta factors is left to the discretion of the respective local regulator and expected to be in line with the Basel II Accord, as the business lines in an Islamic bank may not simply be mapped to the categories identified under the Basel II Accord.

5. INDUSTRY PRACTICE AND IMPLEMENTATION ISSUES FOR OPERATIONAL RISK MEASUREMENT

A robust approach to measuring operational risk requires the following building blocks—data, measurement model, and a mechanism to ensure that model performance is adequately monitored and validated including stress testing (as shown in Exhibit 15.6). These building blocks are common to the operational risk measurement approaches of conventional and Islamic banks. Banks face a host of issues in terms of implementing a sound operational risk measurement methodology. This subsection contains the examination of these issues and description of corresponding remedial actions.

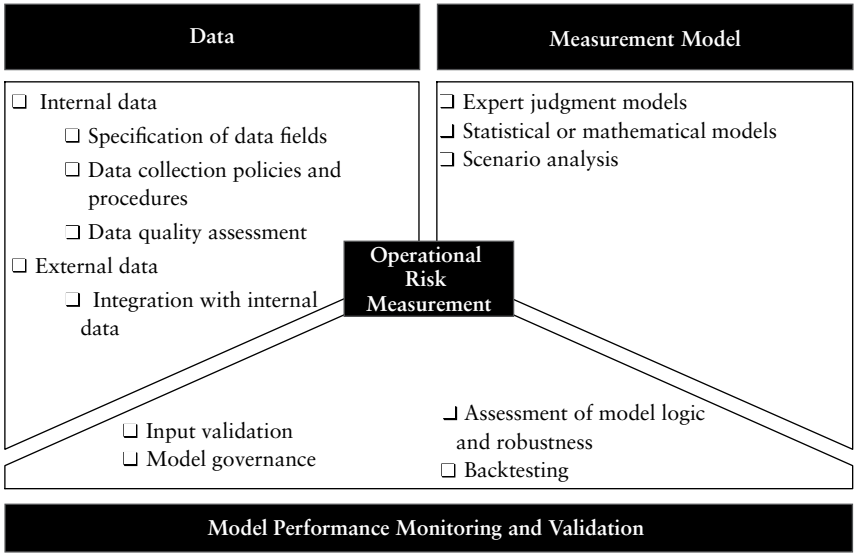


EXHIBIT 15.6 Building Blocks of a Robust Operational Risk Measurement Framework

5.1 Data

Data are a most important element in any risk measurement exercise, be it credit risk, market risk, liquidity risk, or operational risk. The popular adage, "Garbage in, garbage out," summarises it all. If a bank does not meet the minimum standards with regard to the quality of operational risk data, it will not be able to obtain useful output. Unlike market risk or credit risk, collection of operational risk data is more complex because for the following three reasons:

1. The lack of a standard set of event types and business activities. Although the Basel Committee has prescribed the standard set of business lines[13] and event types,[14] the industry is still learning to adapt to them.
2. The lack of a common language used across banks for the classification of incidents into event types. There is a risk that the operational losses get misclassified into a different event type.
3. Sparse data availability. As the quantification of operational risk is a relatively new area, lack of historical data poses challenges for modellers. There are external data providers for operational risk events, like Global Operational Loss Database (GOLD) by the British Bankers' Association, OpBase by Aon, OpRisk by SAS, and OpVar by Fitch, among others, which can provide operational loss data. However, this will require customisation to the individual bank's requirements. At this point in time, the authors are not aware of the existence of any specific external data for the operational losses of Islamic banks, which poses a challenge to obtain operational loss data for the risks that are specific to Islamic banks, like risk of *Shari'ah*–non-compliance and fiduciary risk.

From a data perspective, the following are the five key prerequisites for a robust operational risk measurement framework:

1. To the extent possible, the internal operational loss data should be collected to form the basis for the selection of the operational risk measurement methodology. While using the historical loss database for operational risk measurement, care should be taken to ensure that:
   a. Data are relevant for bank's existing business model. For example, if a bank has transformed from a corporate to a retail bank, the historical operational loss data may hardly be relevant.
   b. An adequate history of operational loss data, say three to five years, is taken.
   c. Proper classification of historical loss data is made into the relevant business units and event types.

   d. Data obtained from self-assessment and scenario analysis exercises should be subject to appropriate validation and challenge to avoid personal biases of individuals taking part in such exercises.
2. Input data should be obtained by a bank using a combination of internal data obtained from risk and control self-assessment and from scenario analysis exercises. The basic premise is—who would know the risks better than the business or process owners themselves? Hence, their participation is critical in the process of generating internal data.
3. Suitable imputations should be made for handling the missing data issues. Wherever required, external data should be used to supplement internal data. This also includes data obtained from a data pooling exercise. However, particular care should be taken to make appropriate adjustments for the following:
   a. Different thresholds used for operational losses in the external and internal databases.
   b. Mapping of external data to internal categories.
   c. Scaling to suit the size of the bank.
4. Data collection policies and procedures should be developed to standardise the process of operational risk data collection. This will require specific guidelines with regard to the incident recognition process, incident recording, and incident assessment and categorisation. The key components of loss data collection policy are shown in Exhibit 15.7.
5. Data quality assessment should include definition of acceptable data quality, data quality objectives,[15] definition of data cleansing, and data validation rules.[16]

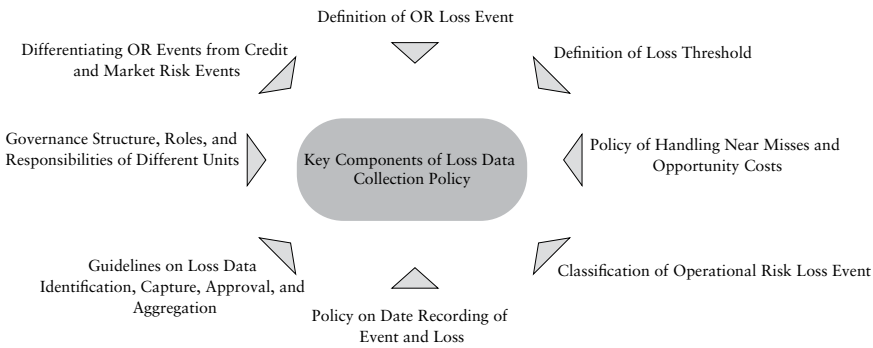

Definition of OR Loss Event
Differentiating OR Events from Credit and Market Risk Events
Definition of Loss Threshold
Governance Structure, Roles, and Responsibilities of Different Units
Key Components of Loss Data Collection Policy
Policy of Handling Near Misses and Opportunity Costs
Guidelines on Loss Data Identification, Capture, Approval, and Aggregation
Classification of Operational Risk Loss Event
Policy on Date Recording of Event and Loss

EXHIBIT 15.7 Key Components of Loss Data Collection Policy

5.2 Measurement Model

There are several measurement models, including proprietary tools available in the market. Banks have a choice in terms of selecting a model from any of the following three categories:

1. Expert judgment model—such models are appropriate in a scenario when a bank has limited or no historical operational loss data. In such a case, the bank hardly has a choice but to resort to an expert judgment model. Operational risk scorecards are used by some banks for measuring their operational risks. Some banks use KRIs to assess the level of operational risks faced by them.

   Another practice followed by some banks in the industry is to use a statistical/mathematical model (like LDA) on the basis of external data, and use that along with the expert judgment model. This results in having a self-correcting mechanism, although not 100 percent accurate, in the operational risk measurement framework.
2. Statistical/mathematical models—such models are data intensive and will require a robust database. A loss distribution approach[17] is an example of this category. Banks intending to use such models should ensure that they are based on both a sound underlying mathematical logic and a business rationale. Otherwise, there is a risk of over-fitting a statistical technique in a dataset, which is very dangerous as it leads to misleading results. It is extremely important to note that off-the-shelf models should only be used when the model logic is transparent.
3. Scenario analysis—this technique is usually combined with some of the other measurement methodologies.[18] Each scenario generated is assessed using a combination of historical losses (external data as well as internal data, as applicable), KRIs, relevant risk factors identified as part of RCSA exercise, a bank's control environment, and relevant industry experience in a particular jurisdiction, before the final assessment is made. The output of this exercise may vary. Sometimes, the results are simply reflected in a heat map, while in other circumstances, a rigourous analysis is carried out and the results are shown in terms of a preliminary loss distribution. A scaling factor, based on expert judgment and empirical data, can be used to convert the expected losses into unexpected losses.

5.3 Model Performance Monitoring and Validation

Operational risk measurement models are relatively new in the industry, and banks should use a comprehensive mechanism to monitor and control model

risks. Some of the key areas that should be regularly and independently monitored by a bank include:

1. Quality of inputs obtained from different systems and departments. For example, there are instances when false alarms are raised because of the lack of interfaces between different systems. Such exceptions should be carefully monitored, and data should be used after proper cleansing. Similarly, when using external data, suitable scaling factors should be used for size and materiality adjustments.
2. Model governance is an important area that should be handled appropriately by a bank. Some of the key areas with regard to model governance that need to be carefully managed are:
   a. Independence between model development, implementation, and validation units should be maintained.
   b. Internal audit function should have involvement in model validation.
   c. Adequate audit trails should be maintained for any changes made in the model.
   d. Board and senior management should have an oversight over the model performance monitoring.
3. Model logic and robustness should be assessed on a regular basis, keeping in mind the underlying assumptions of the model. Inputs should be sensitised, and stress testing should be carried out to check whether the model performs appropriately under stressed scenarios. Empirical relationship between different variables must be examined and reassessed at regular intervals for any significant changes.
4. Backtesting of operational risk measurement models is a difficult exercise, especially when the history of model usage is limited. However, banks should use some interpolation or extrapolation techniques to gauge the overall performance of the model.

In summary, operational risk measurement is an important area for banks and other financial institutions. The magnitude of losses seen in the industry, including the recent losses in some major banks, leaves no doubt that this risk, if not measured and managed well, may have potentially disastrous consequences. Banks should not simply avoid quantifying operational risk on the grounds of unavailability of data. The first step can be the use of external data or data generated from experts' inputs. The second step is to lay down a system so that a data capturing exercise is initiated. Thirdly, a regular assessment of operational risk should be made by the middle and

senior management of the bank, and results should be reported to the board or a board-level committee. Last but not the least, internal audit, risk management, internal control, and compliance functions should regularly share information and identify potential "hot spots" so that adequate management attention can be given for the same.

APPENDIX

Under the standardised approach, banks' activities are divided into eight business lines: corporate finance, trading and sales, retail banking, commercial banking, payment and settlement, agency services, asset management, and retail brokerage. A bank must develop specific policies and have documented criteria for mapping gross income for current business lines and activities into the standardised framework. The criteria must be reviewed and adjusted for new or changing business activities as appropriate. The principles for business line mapping as defined under Basel II guidelines are shown in Exhibit A.1.

For the purposes of internal operational risk management, banks must identify all material operational risk losses consistent with the scope of the definition of operational risk. The loss event types defined under Basel II are presented as Exhibit A.2.

EXHIBIT A.1 Mapping of Business Lines[19]

Level 1	Level 2	Activity Groups
Corporate finance	Corporate finance	Mergers and acquisitions, underwriting, privatisations, securitisation, research, debt (government, high yield), equity, syndications, IPO, secondary private placements
	Municipal/Government	
Finance		
	Merchant banking	
	Advisory services	
Trading and sales	Sales	Fixed income, equity, foreign exchanges, commodities, credit, funding, own position securities, lending and repos, brokerage, debt, prime brokerage
	Market making	
	Proprietary positions	
	Treasury	
Retail banking	Retail banking	Retail lending and deposits, banking services, trusts and estates
	Private banking	Private lending and deposits, banking services, trusts and estates, investment advice
	Card services	Merchant/commercial/corporate cards, private labels and retail
Commercial		
Banking	Commercial	
Banking	Project finance, real estate, export finance, trade finance, factoring, leasing, lending, guarantees, bills of exchange	

Payment and Settlement[20]	External clients	Payments and collections, funds transfer, clearing
Settlement		
Agency services	Custody	Escrow, depository receipts, securities lending (customers), corporate actions
	Corporate agency	Issuer and paying agents
	Corporate trust	
Asset management	Discretionary fund	
Management	Pooled, segregated, retail, institutional, closed, open, private equity	
	Nondiscretionary	
Fund management	Pooled, segregated, retail, institutional, closed, open	
Retail brokerage	Retail brokerage	Execution and full service

EXHIBIT A.2 Detailed Loss Event Type Classification[21]

Event-Type Category (Level 1)	Definition	Categories (Level 2)	Activity Examples (Level 3)
Internal fraud	Losses due to acts of a type intended to defraud, misappropriate property, or circumvent regulations, the law, or company policy, excluding diversity/ discrimination events, which involve at least one internal party	Unauthorised activity	Transactions not reported (intentional)
Transaction type unauthorised (w/monetary loss)			
Mismarking of position (intentional)			
		Theft and fraud	Fraud/credit fraud/worthless deposits
Theft/extortion/embezzlement/ robbery			
Misappropriation of assets			
Malicious destruction of assets			
Forgery			
Check kiting			
Smuggling			
Account takeover/ impersonation/etc.			
Tax non-compliance/evasion (wilful)			
Bribes/kickbacks			

Insider trading (not on firm's account)			
External fraud	Losses due to acts of a type intended to defraud, misappropriate property, or circumvent the law, by a third party	Theft and fraud	Theft/robbery
Forgery			
Check kiting			
		Systems security	Hacking damage
Theft of information (w/monetary loss)			
Employment practices and workplace safety	Losses arising from acts inconsistent with		
Employment, health, or safety laws or agreements, from payment of personal injury claims, or from diversity/ discrimination events	Employee relations	Compensation, benefit, termination issues	
Organised labour activity			
		Safe environment	General liability (slip and fall, etc.)
Employee health & safety rules events			
Workers compensation			
		Diversity and discrimination	All discrimination types

(*Continued*)

EXHIBIT A.2 (*Continued*)

Event-Type Category (Level 1)	Definition	Categories (Level 2)	Activity Examples (Level 3)
Clients, products, and business Practices	Losses arising from an unintentional or negligent failure to meet a professional obligation to specific clients (including fiduciary and suitability requirements), or from the nature or design of a product	Suitability, disclosure, and fiduciary	Fiduciary breaches/guideline violations
Suitability/disclosure issues (KYC, etc.)			
Retail customer disclosure violations			
Breach of privacy			
Aggressive sales			
Account churning			
Misuse of confidential information			
Lender liability			
		Improper business or market practices	Antitrust
Improper trade/market practices			
Market manipulation			
Insider trading (on firm's account)			
Unlicensed activity			
Money laundering			
		Product flaws	Product defects (unauthorised, etc.)

Model errors			
		Selection, sponsorship, and exposure	Failure to investigate client per guidelines
Exceeding client exposure limits			
		Advisory activities	Disputes over performance of advisory activities
Damage to physical assets	Losses arising from loss or damage to physical assets from natural disaster or other events	Disasters and other events	Natural disaster losses
Human losses from external sources (terrorism, vandalism)			
Business disruption and system failures	Losses arising from disruption of business or system failures	Systems	Hardware
Software			
Telecommunications			
Utility outage/disruptions			
Execution, delivery, and process management			
	Losses from failed transaction processing or process management, from relations with trade counterparties and vendors	Transaction capture, execution, and maintenance	Miscommunication
Data entry, maintenance, or loading error			
Missed deadline or responsibility			

(*Continued*)

EXHIBIT A.2 (*Continued*)

Event-Type Category (Level 1)	Definition	Categories (Level 2)	Activity Examples (Level 3)
Model/system misoperation			
Accounting error/entity attribution error			
Other task misperformance			
Delivery failure			
Collateral management failure			
Reference data maintenance			
		Monitoring and reporting	Failed mandatory reporting obligation
Inaccurate external report (loss incurred)			
		Customer intake and documentation	Client permissions/disclaimers missing
Legal documents missing/ incomplete			
		Customer/client account management	Unapproved access given to accounts
Incorrect client records (loss incurred)			
Negligent loss or damage of client assets			
		Trade counterparties	Nonclient counterparty misperformance
Miscellaneous nonclient counterparty disputes			
		Vendors and Suppliers	Outsourcing
Vendor disputes			

NOTES

1. Legal risk includes, but is not limited to, exposure to fines, penalties, or punitive damages resulting from supervisory actions, as well as private settlements.
2. BCBS, "International Convergence of Capital Measurement and Capital Standards—A Revised Framework" (also referred to as Basel II Accord), updated November 2005, 140.
3. Qualitative assessment of operational risk has been practiced in the banking industry for quite some time in different forms. For example, the internal audit departments have been assessing the risks and controls, including operational controls, in different banks mainly on a post-fact basis.
4. Subject to the local regulatory requirements.
5. The specific details of the capital calculation for operational risk are covered in Section 3.2.
6. BCBS, "Operational Risk—Supervisory Guidelines for the Advanced Measurement Approaches," June 2011, 2.
7. Prior to this, banks were required to follow BCBS's Sound Practices for the Management and Supervision of Operational Risk, 2003.
8. Details are given in Exhibit 15.4 and appendices.
9. A convolution is a mathematical operation on two functions producing a third function that is a modified version of one of the original functions. It is somewhat similar to cross-correlation.
10. Specific data issues faced by banks during the implementation of AMA or an advanced approach are discussed in Section 5.1.
11. Under AMA, it is expected that a bank's regulatory capital for operational risk will be the sum of its expected losses and unexpected losses due to operational risk, unless the bank can show that it has accurately measured and made provisions for the expected losses. For credit and market risk, expected losses are routinely covered by provisions, but this may not be the case for operational risk, in which case capital needs to be provided.
12. IFSB, Capital Adequacy Standards for Institutions (other than Insurance Institutions) offering only Islamic Financial Services, December 2005, 18.
13. Exhibit A.1, Appendix.
14. Exhibit A.2, Appendix.
15. For example, not more than 10 percent of the missing data fields, reconciliation errors not exceeding 5 percent, and so on.
16. Include sense checking of data and its relevance to the business of the bank, technical rules like parsing, data duplication, missing value treatment, min-max rules, and so on.
17. Please refer to Section 3.3 for more details.
18. Some practitioners may classify this methodology under Expert Judgment, although it is usually a combination of quantitative analysis and expert judgment.

19. BCBS, International Convergence of Capital Measurement and Capital Standards—A Revised Framework (also referred to as Basel II Accord), updated November 2005, 254.
20. Payment and settlement losses related to a bank's own activities would be incorporated in the loss experience of the affected business line.
21. BCBS, International Convergence of Capital Measurement and Capital Standards—A Revised Framework (also referred to as Basel II Accord), updated November 2005, 257.

CHAPTER 16

Liquidity Risk

Richard Thomas

1. INTRODUCTION

Liquidity is defined by the Basel Committee on Banking Supervision (BCBS) as "the ability of a bank to fund increases in assets and meet obligations as they become due, without incurring unacceptable losses."[1] Liquidity risk in banking is thus often defined as "the risk that the bank becomes unable to fund increases in assets and meet its financial obligations as they fall due." It is also the risk of loss related to premature or inappropriate liquidation of assets, where the asset–liability mix has been poorly managed and value has been wrongly determined (e.g., collateralised debt obligations in U.S. subprime securitisations).

As such, liquidity is derived from both sides of a bank's balance sheet. Specifically, it comprises:

- The ability to turn bank assets into funds.
- The ability to raise liabilities to fund the bank's assets.

Regulators are paying a great deal more attention to liquidity risk ratios since the fallout from the financial crisis, evident in changes in new iterations of the Basel Accords. However, their attention is drawn to the systemically risky global banks, and there is a question mark hanging over the appropriateness of the "one size fits all" regulations to measure this risk in smaller, and particularly in Islamic, banks.

2. THE REGULATORY RESPONSE TO LIQUIDITY RISK

Basel II has rightly and often been criticised for its concentration on bank capital and for subsequently paying little attention to bank liquidity and its management.

Islamic Finance: The New Regulatory Challenge.
Edited by Simon Archer and Rifaat Ahmed Abdel Karim
Copyright © 2013 by John Wiley & Sons Singapore Pte. Ltd.
ISBN: 978-1-118-62897-3

The new Basel III regulatory proposals attempt to address this deficiency and to improve the liquidity position of banks in three ways:

1. Curbing their ability to create a large maturity mismatches, including the imposition of a "stable funding ratio."
2. Ensuring that over a 30-day period they have a positive daily cash flow (i.e., that their daily "cash inflow" from *inter alia* maturing assets and contracted funding is greater than their daily "cash outflow" from *inter alia* contractual lending obligations and maturing deposits).
3. Ensuring that they hold a quantity of assets that can be turned into cash through markets, and in case of need through the opening of a discount "window" at the central bank: an issue that will be addressed in the section on eligible instruments and *sukuk*.

Islamic banks would as a matter of principle overlay the conventional definitions of risk with avoidance of *gharar* (uncertainty) and *jehala* (ignorance) to ensure their *Shari'ah* compliance. The removal of uncertainty and ignorance from the *Shari'ah*-compliant business and contracts underlying the asset and liability risk does a great deal to enhance the characteristics of the balance sheet if assiduously applied. The section below suggests that in evaluating liquidity risks of Islamic banks compared to their conventional counterparts, the measurement tools should give greater consideration to certain types of underlying *Shari'ah*-compliant contracts. It is often stressed, when making the case for dedicated risk measures for Islamic banks, that "risk is agnostic," and there are no religious implications for risk measurement. This ignores the influence of *fiqh al-muamalat* (Islamic commercial jurisprudence) applicable to dealings between men on the Islamic economic model. This model encourages Islamic banks to fundamentally understand the business they undertake and to constrain it to dealings in the real economy. This is quite a separate recognition of structure and practice that conventional banks could as easily follow. Indeed, with the increased focus by regulators on the mis-selling of conventional retail banking products and of the "socially useless" nature of some wholesale products, it could be argued that conventional bank regulators are heading in the same direction. The section below on Bank of England Trade Bills is an example of how the conventional market has diverged from the real economy-based approach, and this may be extrapolated across many geographic markets.

3. ASSET LIQUIDITY

The ability to turn assets into cash through liquid markets is a very important aspect of bank liquidity management, and this is one aspect of *Shari'ah*-compliant banking that often causes concerns for *Shari'ah* bank treasurers in

the management of their banks' balance sheets. The reverse *murabahah* and *tawarruq* solutions based on commodity *murabahah* transactions (CMTs), which are attracting comment for a variety of reasons, are examples of seeking to increase liquidity in the balance sheet of Islamic banks.

Much has been written since the start of the financial crisis in 2007 of the problems that conventional banks and investors faced as financial asset markets became illiquid as a result of investors and market makers withdrawing from these markets. In practice, there are also much the same problems in some *Shari'ah*-compliant asset markets, including the *sukuk* market. *Shari'ah*-compliant banks in general, however, did not have the same level of problems as conventional banks. On the asset side of their balance sheets this was in part due to the nature of their assets. Whilst much is made of the ability to turn assets into cash funds through markets, assets also possess a degree of natural liquidity through the term of the assets themselves and the process leading to their liquidation. Examples are realisation of the sale of goods upon reaching market, or a fixed asset with a strong natural cash flow servicing it—for example, well-let (i.e., leased or rented) real estate—that can be valued, as compared to general borrowings or contracts based on speculative premises, or, as in subprime mortgages, lacking transparency and thus inherently difficult or impossible to value. A bank that has books of short-dated self-liquidating assets will be more naturally liquid than one that possesses books of long dated assets. Empirical tests tend to illustrate that Islamic banks tend to fall into the former category.

4. TRADE FINANCE ASSETS AS LIQUIDITY

Shari'ah-compliant banks, as a result of adherence to *Shari'ah* principles, are primarily involved in the finance of the real economy, including the financing of trade in goods and services, which forms a major part of the business of many such banks. Much of this trade finance is short-term in nature, typically between 30 and 90 days, and thus books of such assets provide a steady stream of repayments, which can if not replaced with new business provide a source of liquidity to a bank. More emphasis might be paid to the "self liquidating" nature of these assets and a "merchant bank's" ability to reconcile the finance to the trading condition of its counterparties and their liquidation against sales. This should also be extrapolated in the distinction between commodity *murabahah* and genuine *murabahah* (even in commodities) where the finance (credit) arises from the sale of the specific, identified physical goods, rather than being a pure financial debt, so that the finance may also be secured on the underlying goods throughout their natural transformation cycle. Transparency is further improved in genuine *murabahah* in commodities by the requirement to price against publically

advertised prices and to protect against, for example, deterioration in quality of the underlying goods.

The importance of both funding the real economy and of the funding by banks of short-term (naturally liquid) assets was for a period of about 200 years seen by regulators as of great importance to the stability of both individual banks and the banking system as a whole. Thus, the Bank of England throughout most of the nineteenth and twentieth centuries emphasised the importance of "trade bills" (short-term trade-based debt instruments). This was not fully replaced by a requirement for banks to hold only government bonds until Basel I became the basis for global banking regulation in the late 1980s. Sheikh Saleh Kamel made some progress in promoting liquidity through trade bills rather than commodity *murabaha*. The proximity of *riba* (interest) was at the time considered too great; however, a modern study may well back up his original conception.

5. GOVERNMENT BONDS AND LIQUIDITY

The requirement for banks to hold stocks of government bonds as a source of liquidity places heavy reliance on the ability of markets in such assets to stay liquid through having continuous participation of willing issuers and investors as well as market-making institutions. Whilst some markets have these characteristics, it is clear that in the ongoing crisis this is not true for a number of countries, including important euro area countries. Once such markets become illiquid, the dangers of such reliance become very obvious as government bonds are often of very long tenor (UK government bonds have an average life of around 16 years) and thus are naturally very illiquid. The importance attached to government bonds as liquid assets has important implications for *Shari'ah*-compliant banks in many countries, as very few countries issue *sukuk* that are sufficiently market-liquid to be used as bank liquidity. This is true in the United Kingdom, where the lack of a sterling *sukuk* of sufficient quality to be recognised by the Bank of England challenges the five Islamic banks there to meet solvency tests, despite the fact that those banks are all naturally "over-liquid."

6. ASSET-BASED FINANCINGS AND LIQUIDITY

Shari'ah-compliant banks in all long-term financing structures have a strong reliance on the assets they are funding as a source of financial returns and eventual repayment of the financing. An Islamic bank is charging for the use

of the assets it has financed by taking a return based upon their use. In conventional terms these structures are much like project financings and/or securitisations. Such financings are to some extent likely to be subject to extension risk, though the likelihood of default is itself reduced by the flexibility inherent in the structures.

Some securitisation structures fared very badly in the recent financial crisis, most notably those connected to highly geared and/or derivatives-based structures, neither of which are features of *Shari'ah*-compliant finance structures. In the light of subsequent events, however, many of the more conventional securitisation structures have performed well. Nevertheless, as a result of the bad outcomes, the treatment by regulators of securitisation structures both for capital and liquidity purposes is likely to be disadvantaged against asset-backed structures such as covered bonds.

The development of the Islamic covered bonds market is one of the keys to the development of the Islamic capital markets. Many traditional conventional covered bond structures are unlikely to be *Shari'ah* compliant, as in many instances these are simply senior debt instruments with security backing provided by what are often substitutable and opaque asset structures, German Pfandbriefen being a case in point. This lack of transparency in structure, asset, and substitution terms is clearly introducing *gharar*, and the delinking of assets to transparent pricing is also likely to constitute an issue in respect of both equivalence (introducing by default *riba al-fadl*) and the immediateness of the transaction (which introduces *riba al-nasiah*). However, in Malaysia, with the close involvement of Cagamas,[2] a great deal of quiet progress has been made, and this development demands more participation and study by Islamic banks globally.

There is also a healthy coincidence of needs between the developing markets requirements for *Shari'ah*-compliant home financing, the suitability of covered bonds, and the natural *Shari'ah* prohibitions on the kind of structures in securitisation that led to U.S. subprime defaults.

The IFSB Islamic Financial Stability Forum, as well as the G20 Financial Stability Board review particularly, noted the requirement for high quality liquid assets.

7. THE INTERNATIONAL ISLAMIC LIQUIDITY MANAGEMENT CORPORATION (IILM)

The IILM was established on October 25, 2010, largely through the actions of the Islamic Financial Services Board (IFSB) and its then secretary general, Professor Datuk Rifaat Ahmed Abdel Karim. There are 13 initial signatories to the establishment of the IILM though others may join at a later date; 11 of

the 13 are central banks, including those of Malaysia, Iran, Turkey, and some Gulf countries, and all 13 signatories are IFSB members.

The IILM was established with the primary objective of issuing *Shari'ah*-compliant financial instruments to facilitate more efficient and effective liquidity management solutions for the Islamic banking industry. It is expected, initially, to focus on the issue of short-term paper in international reserve currencies.

IILM will issue *sukuk* in the name of the company itself whilst individual central banks may act as custodians for the assets that underpin the *sukuk*. Alternatively, the IILM could establish a central custodian agency.

A spokesman for IILM has also stated: "You move the asset to the central bank because that will raise confidence of the buyers of the *sukuk*." It is also believed that this would help the issues to obtain top credit ratings that qualify them to be used in banks' liquidity management.

What may be emerging is a liquidity product with some or all of the following features:

- Underpinned by short-term self-liquidating real trade transactions.
- Backed by real assets, held to the order of the funds provider.
- Asset holder (or holders) to be undoubted.
- Transactions centrally recorded (and registered).
- Active secondary market in the product.

In pursuit of this, the IILM product should have a number of the features and benefits of a central counterparty.

Compared to the central custodian agency alternative, the custodial activities of the individual central banks is potentially, however, a weak point in the structure, to the extent that the diversity of custodians may detract from the benefits of a central counterparty in that:

- Information may be less well coordinated and may not be standardised.
- The contractual rights of creditors may differ if the central banks use their own laws as the law of jurisdiction of the contracts.

In both instances this could detract from what otherwise would be support for one of the more important features of new emerging banking regulation, the requirement of greater transparency in instruments and in markets.

The likely features of the product could create a close parallel with the features of the historic eligible trade bills product and if accepted, as expected, by central banks as liquid instruments may provide a beneficial diversity to bank liquidity and its management.

8. LIABILITIES (DEPOSITS) AS LIQUIDITY

As a result of the problems of illiquid asset markets, regulators have begun to place much more emphasis on banks' funding liquidity and specifically upon:

- A bank's retail deposit base as a stable source of funds.
- A bank's ability to fund long-term by the issuance of senior unsecured debt instruments.

8.1 Stable Deposits

The stability of a bank's retail deposit base is directly linked to the bank's size and scope of business in relation to the size of the economy within which it operates. If a bank has a significant share of a country's retail deposit base, it is highly unlikely to suffer significant defection of its customers to other banks and any attrition is, given the very similar terms and conditions of retail customer accounts in most countries, likely to be matched by customers defecting to it from other banks: the "law of large numbers" applies.

One would normally suggest that a small bank might suffer such defections, as the "law of large numbers" does not apply. Moreover, it is likely to be concentrated geographically and if in a declining area cannot rely upon branches in other areas to grow more rapidly. It is notable that during their development phase, such "national" Islamic banks—for example, Dubai Islamic Bank, Qatar Islamic Bank, Kuwait Finance House (KFH), and others—did not suffer so because of their unique sales proposition (USP) as *Shari'ah*-compliant banks, which allowed them to attract business across a wide geographic range both within and across economies. Generally, even today these banks have greater protection from defection by virtue of their USP as distinct from their emergence as "large number" players in their local markets. If a bank is also in both retail and corporate markets, moreover, its intra-month deposit base will be more stable as balances tend to move between the retail and corporate sectors of the economy within each month as wages are paid and goods and services purchased by the retail sector. This is a particularly evident trait of the commercial Islamic banks such as KFH.

Shari'ah-compliant banks are, however, more reliant on retail balances than their conventional competitors, and where they are large they do tend to have stable balances, a status that is enhanced by their offering of profit-sharing investment accounts (PSIA—see Section 8.2), which form part of the USP described above.

Apart from PSIA, however, *Shari'ah*-compliant banks are unable to issue longer-term financing instruments, as they cannot compete with

conventional banks in issuing senior debt instruments, which are interest-bearing. In principle, they could issue *sukuk* to raise longer-term funding, but so far this solution has been little used because of the limitations of *sukuk* markets, among other reasons.

8.2 Profit-Sharing Investment Accounts

PSIA involve an equitable sharing of profits between the parties involved in a financial transaction. However, the account holder bears the risk of loss in the absence of misconduct and negligence on the part of the bank. In one structure found in the Islamic banking business, known as the two-tier *mudarabah*, there are three parties—the entrepreneur or the actual user of capital, the bank which serves as a partial user of capital funds and as a financial intermediary, and the depositors (investment account holders) in the bank who are the suppliers of savings or capital funds. There is thus a partnership (*mudarabah*) between the depositors and the bank, and a similar partnership between the entrepreneur and the bank.

In this structure, the bank does not receive a fixed rate of interest on its outstanding financing. Rather, it shares in the profits of the business owner to whom it has provided the funds. Similarly, those individuals who deposit their funds in a bank will share in the profit but bear any losses related to the investments financed by their funds. Typically, however, Islamic banks provide financing on a variety of bases, such as *murabahah, salam* and *istisna'a* (all forms of working capital or project finance), or *ijarah* (leasing and lease-to-buy), as well as diminishing *musharakah* (where the bank advances funds to a customer on a partnership basis, but its share is progressively bought out by the customer).

The emphasis of some *Shari'ah*-compliant banks on PSIA as a secure source of funding must, however, be qualified, as the nature of the reserves (so-called profit-equalisation reserves—PER) held against these accounts that are required by some regulatory authorities is likely to be problematic for both:

- Bank regulators who in many countries have fought a long battle with banks to eliminate so-called reserve accounting in the banking industry, which they accuse of being a method of smoothing bank profits. In fact, PER are used to smooth profit *payouts* to PSIA, but in the absence of transparency may give a misleading impression of the smoothness or persistence of the underlying profit stream.
- International Financial Reporting Standards (IFRS) which, as implemented, also outlaw the use of "hidden reserves" (i.e., reserves disguised as provisions) to smooth profits, and require transparency in the use of both reserves and provisions.

Both of these factors may make PLS deposits less attractive unless steps are taken to reform their structure. This (and particularly the transparency aspect) is an area to which the IFSB has been drawing attention in its standards for a number of years now, as well as suggesting that from a corporate-governance perspective the nature of the risk reward structure between shareholders and PSIA holders is worthy of more review.[3] It is likely that Basel III will underpin their calls for greater transparency in these accounts.

9. ACCOUNTING FOR LIQUIDITY AND FAIR VALUE

Fair-value accounting does not always accurately reflect the business models used by banks and does not result in a close match between bank accounting valuations and the internal performance measures or procedures for management of risk exposures used by different business divisions. This can lead to the liquidity risk described in the beginning, leading to greater risk of failure, and certainly greater risk of loss, if bad asset composition leads to inappropriate disposals. Do the IFRS contribute to that scenario? Under older arrangements, accounting treatments for bank exposures were clearly distinguished along business lines, with "trading book" activities all marked to market, and "banking book" treated entirely on an historical accruals basis. As loans and other credit exposures were being increasingly traded, the lines between banking and trading books were being blurred, suggesting a need for a more consistent treatment between the different business lines. But the mix of valuation procedures introduced by IAS 39 exacerbated profit recognition problems. This continues to cause issues for treatment of, say, *sukuk* portfolio liquidity.

The application of fair value accounting by IFRS to debt liabilities of conventional banks, resulting in changes in the credit ratings of banks' debt securities potentially impacting their income, will not affect *Shari'ah*-compliant banks who do not issue such debt capital instruments.

Achieving a better correspondence between accounting standards and underlying business models is critical for both investor transparency and the comprehensiveness of management information. But is the body (the Accounting and Auditing Organisation for Islamic Financial Institutions, or AAOIFI), which since the mid-1990s has issued financial reporting standards for Islamic banks, equipped to take on the responsibility to adapt and supplement, where necessary, the IFRS for application to Islamic banks position? The area of financial instruments has proved particularly challenging for the International Accounting Standards Board and is likely to be at least equally problematic in the context of Islamic finance. Moreover, international Islamic banks, and indeed any such bank operating in a country that does not accept AAOIFI standards (the ones that do include

Bahrain, Qatar, Nigeria, Pakistan, and Sudan) require some other source of financial reporting standards.

10. ISLAMIC BANKS AND THE BASEL III LIQUIDITY MEASURES

The BCBS has proposed two new metrics to be used in liquidity risk management: the liquidity cover ratio (LCR) and the net stable funding ratio (NSFR). Both are proving to be problematic for conventional banks.

The LCR requires banks to hold a stock of high quality liquid assets (HQLA), meaning paper with a high quality credit rating that is at least equal to total net cash outflows over a period of 30 days. Apart from government paper, there are few types of HQLA—and some government papers are far from qualifying. The problem is even more acute for Islamic banks, which cannot hold interest-bearing paper. The establishment of the IILM mentioned above is intended to mitigate this situation.

So far as the NSFR is concerned, *available stable funding* = equity, *sukuk*, and liabilities (+ a core percentage of UPSIA, or unrestricted PSIA) expected to be a reliable source of funds over one-year time horizon under conditions of extended stress. As noted above, few Islamic banks have so far issued *sukuk* to provide longer-term funding. In addition, the trend towards using CMT-based term deposits (typically with maturities of six months or less) in place of UPSIA is likely to aggravate the problem.

The shifting stance of Basel on the composition of the LCR has allowed sufficient flexibility for the position of "*Shari'ah*-compliant banks" to be considered. Changes are ongoing but in the context of this article the most recent is also the most significant. The Group of Governors and Heads of Supervision (GHOS), the oversight body of the Basel Committee on Banking Supervision, met on 6 January 2013 to consider the Basel Committee's amendments to the Liquidity Coverage Ratio (LCR) as a minimum standard. The subsequent announcement included important inclusions for *Shari'ah*-compliant banks.

Basel III High Quality Liquid Assets (HQLA) The GHOS recognised that: "*Shari'ah* compliant banks face a religious prohibition on holding certain types of assets, such as interest-bearing debt securities. Even in jurisdictions that have a sufficient supply of HQLA, an insurmountable impediment to the ability of *Shari'ah* compliant banks to meet the LCR requirement may still exist. In such cases, national supervisors in jurisdictions in which *Shari'ah*-compliant banks operate have the discretion to define *Shari'ah*-compliant financial products (such as *sukuk*) as alternative HQLA applicable to such banks only, subject to such conditions or haircuts that the supervisors may require. It should be noted that the intention of this treatment is not to allow *Shari'ah*-compliant

banks to hold fewer HQLA. The minimum LCR standard, calculated based on alternative HQLA (post-haircut) recognised as HQLA for these banks, should not be lower than the minimum LCR standard applicable to other banks in the jurisdiction concerned. National supervisors applying such treatment for *Shari'ah*-compliant banks should comply with supervisory monitoring and disclosure obligations."[4]

These supervisory and disclosure obligations include:

- A clearly documented supervisory framework
- A disclosure framework

Also in Annex 2 of the release, which includes a complete list of the changes made to the December 2010 release, includes a specific reference to *Shari'ah*-compliant banks. It is mentioned under **Alternative liquid asset (ALA) framework** with the bullet point "Development of the alternative treatments and include a fourth option for *Shari'ah*-compliant banks" and indicates ongoing work in this area.

This recognition of *Shari'ah* banks compliance issues is very welcome and is an important step towards incorporating *Shari'ah* banks into the Basel regulatory framework. It is, however, not sufficient for *Shari'ah* banks to be fully compliant with many jurisdictions liquidity frameworks. There is hope that GHOS will follow up on indications that it will enable "*Shari'ah*-compliant central banks deposits."

11. CONCLUSION

I strongly believe that the time is right for engagement with global regulators to ensure that Islamic banks can fit into the global financial system. This would accomplish three goals:

1. Allow Islamic banks to compete globally with conventional banks.
2. Create, as far as possible, a level playing field for such competition.
3. Ensure that the instruments through which banks obtain liquidity, both from markets and, in need, from central banks, meet *Shari'ah* principles and are effective liquidity instruments.

I have argued that in a number of ways, global regulation is moving in a direction that is more compatible with *Shari'ah* principles. There is clearly a recognition by regulators of these two aspects of international finance:

1. Conventional banking has become too divorced from the "real economy," and the problems this has caused need to be addressed through changes to global banking regulation.

2. A government bond should not be the only instrument for which banks may provide as "stock" liquidity, and over-reliance on government bonds as a source of liquidity has created major problems, not just for banks but for government and central banks, when direct intervention in markets is required to make monetary policy effective.

Such engagement between those representing the interests of Islamic banks and the global regulators will not be without issues for both. It is hoped that the arguments I have outlined above provide an illustration of some of the areas where engagement is most required and may be most contentious. In particular, it is crucial that the handicaps Islamic banks face in managing liquidity risk be addressed by national authorities (so as to provide *Shari'ah*-compliant substitutes for the conventional interbank markets and lender-of-last-resort facilities, as well as the global regulators in terms of what may count as high quality liquid assets.

There is, however, a more fundamental need for both radical change in global banking regulation and a recognition of this by global regulators. If we are to create a better banking system that is more mindful of the needs of the real economy and of banks' duty to their customers, then I firmly believe Islamic banking illustrates an approach to banking that, by avoiding speculation and remaining linked to the real economy, provides examples of how complying with these imperatives could be of benefit to all societies.

NOTES

1. BCBS, *Principles for Sound Liquidity Risk Management and Supervision*, September 2008. The definition of liquidity risk in the Islamic Financial Services Board's *Guiding Principles on Liquidity Risk Management* employs a similar wording.
2. Cagamas is a state-sponsored institution that acquires Islamic mortgages from their originators and packages them into pools which it securitises as *sukuk*—somewhat like Fannie Mae and Freddie Mac in the United States. As Cagamas is a highly rated institution to which the *sukuk* holders have recourse, the *sukuk* it issues also benefit from a high rating.
3. See, for example, IFSB-3 *Guiding Principles on Corporate Governance for Institutions offering Islamic Financial Services* (December 2006) and IFSB-4 *Disclosures to Promote Transparency and Market Discipline for Institutions offering Islamic Financial Services* (December 2007).
4. Basel iii Compliance Professionals Association (BiiiCPA) www.basel-iii-association.com

PART

Three

Securitisation and Capital Markets

CHAPTER 17

Securitisation in Islamic Finance

Baljeet Kaur Grewal

Securitisation as a financing option has long been a popular mechanism for raising funds in the conventional context. In Islamic finance, the concept of securitisation takes on a more fundamental role as an intermediation between the issuer and the investor, the nature of the underlying assets, and the financial market at large, leveraging off the "asset-based" nature of the Islamic industry as a whole. Islamic securities known by the Arabic term *sukuk* (investment certificates) are issued for this purpose. This chapter will seek to provide an analysis on securitisation from a *sukuk* angle, studying its growth, depth, and potential through recent issuances, historical benchmarks, and performance using empirical data from a practitioner's perspective.

1. PREFACE: AN OVERVIEW OF THE *SUKUK* MARKET

The *sukuk* market provides a range of much needed *Shari'ah*-compliant instruments having return characteristics, making them substitutes for conventional fixed-income instruments for investment by financial institutions and other investors that seek *Shari'ah*-compliant instruments as an alternative asset class. The "fixed-income-like" characteristics of such *sukuk* derive not from contractual obligations of the originator or issuer, as with conventional fixed-income instruments, but from the nature of the underlying securitised assets, which have a highly predictable income stream. As such, these *sukuk* are classed by financial analysts as "fixed income." Between 2001 and 2011 the primary *sukuk* market grew at a compound annual growth rate (CAGR) of 59.2 percent to reach US$85.1 billion at the end of 2011, as shown in Exhibit 17.1. *Sukuk* issuance has made

Islamic Finance: The New Regulatory Challenge.
Edited by Simon Archer and Rifaat Ahmed Abdel Karim
Copyright © 2013 by John Wiley & Sons Singapore Pte. Ltd.
ISBN: 978-1-118-62897-3

a remarkable expansion in 2011, outpacing 2010 estimates, seeing a year-to-date increase of 88.4 percent at the end of 2011. Similarly, the secondary *sukuk* market reached US$178.2 billion worth of outstanding papers at the end of 2011, as shown in Exhibit 17.1. Issuers include Islamic financial institutions, corporates and sovereigns in both the Asian and Middle Eastern regions. The rapid growth of the *Shari'ah*-compliant "fixed income" market comes at a time of serious turmoil in the conventional bond markets against the backdrop of a global financial crisis, and underscores the strength and economic fundamentals of the *sukuk* market.

By region, Southeast Asia (SEA) holds the largest share of *sukuk* issuances, representing 76.9 percent of the primary market in 2011, followed by the Middle East and North Africa (MENA) region (23.0 percent), as shown

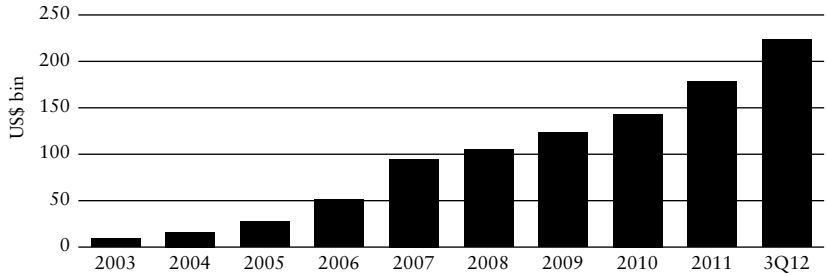


EXHIBIT 17.1 *Sukuk* Outstanding Trend

Source: KFHR.

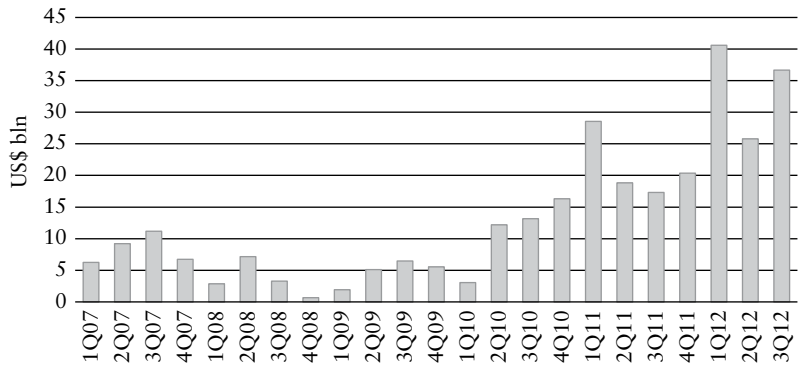


EXHIBIT 17.2 *Sukuk* Issuance on a Quarterly Basis

Source: KFHR.

Note: The average quarterly issuance in 2012 is US$34.3 billion as compared to only US$20.0 billion in 2011 and US$11.2 billion in 2010.

in Exhibit 17.3. The year 2011 saw a number of new jurisdictions open up to the *sukuk* market, among them potentially large Muslim markets including Jordan, Iran, and Yemen, as shown in Exhibit 17.4. The depth of the market is further underscored by the multitude of investors who have raised *sukuks* (Exhibit 17.5). Notably, a key development was the introduction of the international financial district of Hong Kong, which has been planning to debut the market since 2007 but was delayed due to the global financial crisis.

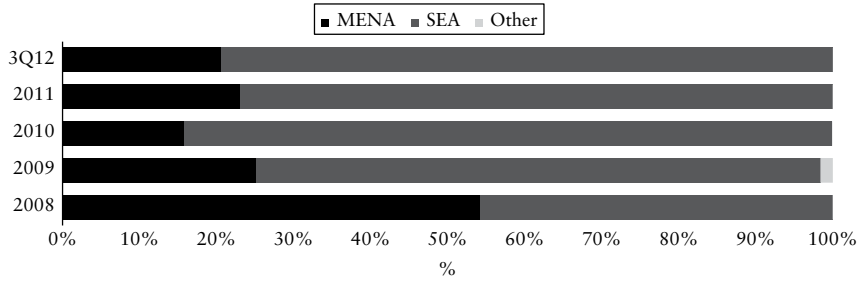


EXHIBIT 17.3 Sukuk Issuance by Region (2011)
Source: KFHR.

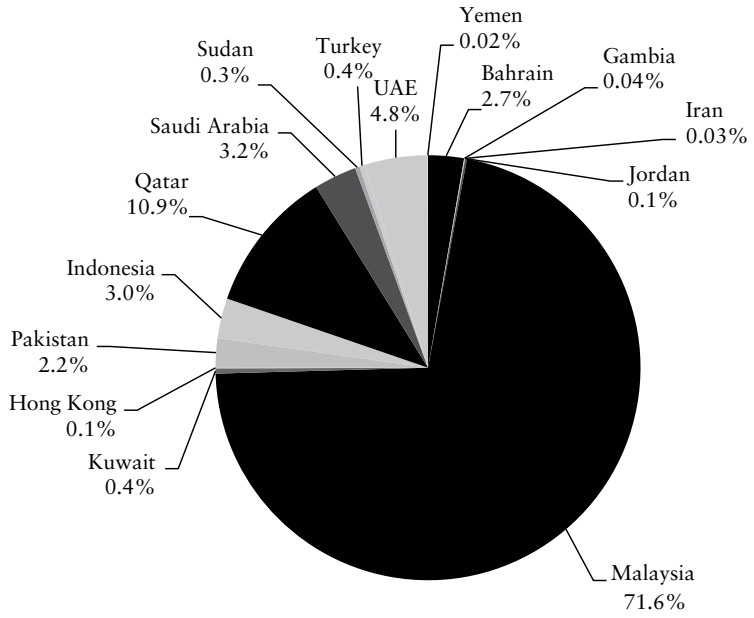


EXHIBIT 17.4 Sukuk Issuance by Domicile (3Q12)
Source: KFHR.

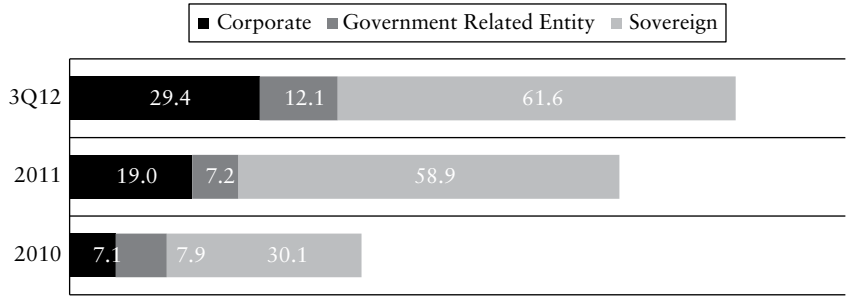


EXHIBIT 17.5 Issuance by Type (US$ Billion)
Source: KFHR.

This initiative, when recognised, will at once open a new market to investors with links to China and new asset classes which will catapult *sukuk* into a new realm of investment.

Based on 2011 data, *sukuk* issuances were dominated by sovereign issuers looking to raise funds as a means of replenishing fiscal budgets for socioeconomic activity. In 2011, corporates had also returned to the primary market after either cancelling or delaying plans in 2010 as the Dubai real estate bubble burst and the impact of the financial crisis was felt throughout Asia and the Middle East. On a year-on-year basis, corporate *sukuk* are up 167.6 percent to US$19.0 billion issued in 2011 from the US$7.1 billion issued in 2010 as shown in Exhibit 17.5. Of these corporate *sukuk*, US$12.4 billion or 65.0 percent were issued in Malaysia, while US$3.1 billion (16.4 percent) and US$2.0 billion (10.8 percent) were issued in the UAE and Saudi Arabia, respectively. Of the total issuances in 2011, corporate issuers made up 21.9 percent of the U.S. dollar amount versus 16.3 percent in 2010. There are a number of reasons for corporates to issue *sukuk*. These include financing the following:

- Project, infrastructure and real estate financings.
- Corporate financings.
- Investment funds of all types.
- True asset securitisations.

2. SECURITISATION AND *SUKUK*: SOME GENERAL REMARKS

Financial institutions and businesses use securitisation to fund their operations and to immediately realise the value of a cash-producing asset. The pool of assets is usually composed of assets such as financing, but can also be trade receivables or leases. In most cases, the originator or provider of assets

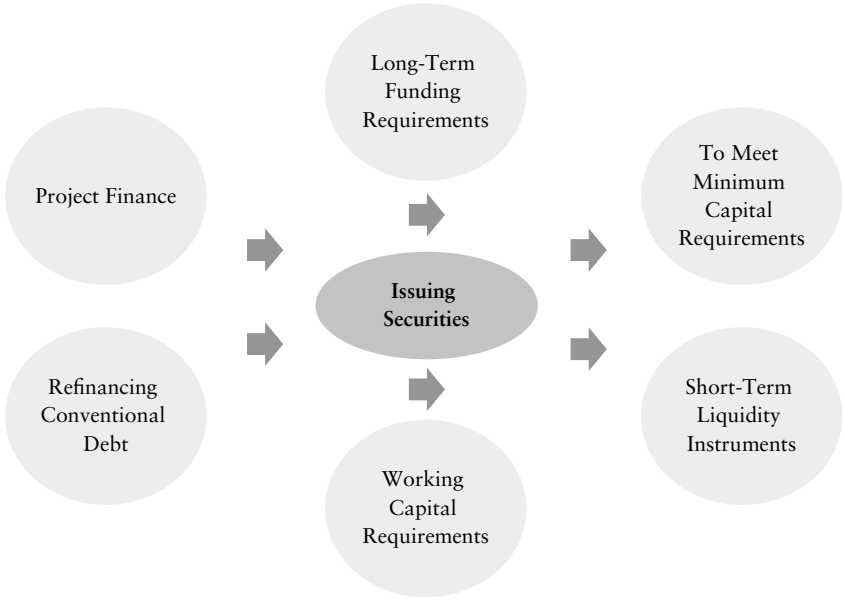


EXHIBIT 17.6 Reasons for Issuing Sukuk
Source: KFHR.

is expecting a regular stream of payments over those assets. By pooling the assets together, the payment streams can be used to support principal payments on securities.

One of the benefits for the originator from securitising assets is that the originator receives full value for assets rather than an extended payment stream spread out over time. Thus the originator will invest this sum of proceeds received from the securitised assets to fund further growth in its asset book. This supplements the need for the originator to raise funds by more traditional methods. Also, securitisation structure permits firms to effectively move and hold their assets off-balance sheet. This generates higher leverage and greater economies of scale. Furthermore there are many other purposes for originators in choosing the Islamic securitisation path, as shown in Exhibit 17.6.

A company that wants to obtain financing through securitisation begins by identifying assets that can be used to raise funds. These assets typically represent rights to payments at future dates and are usually referred to as "receivables." The credit risk that these payments may not be made on time is an important factor in valuing the receivables. As long as the originator can reasonably predict the aggregate rate of default, it can securitise even

those receivables that present some risk of uncollectibility. A statistically large pool of receivables due from many obligors, for which payment is reasonably predictable, is generally preferable to a pool of a smaller number of receivables due from a few obligors.

After identifying the assets to be used in the securitisation, the originator transfers the receivables to a newly formed special-purpose corporation, trust, or other legally separate entity often referred to as a special-purpose vehicle (SPV). The transfer is intended to separate the receivables from the risks associated with the originator. Further, it will be important to the originator (especially for regulatory capital purpose) that the assets are no longer treated as being on its balance sheet. For this reason, the originator will often structure the transfer so that it constitutes a "true sale," a sale that is sufficient under bankruptcy law to remove the assets from the originator's bankruptcy estate.

The SPV issues securities in the Islamic capital markets to raise funds in order to purchase those assets. The SPV, however, must be structured as "bankruptcy remote" to ensure that the purchasers of these securities see their investment as being against the securitised assets only and not subject to the risk of failure of the SPV. Otherwise, the ratings of the issuer of the capital market securities will be adversely affected. Bankruptcy remote in this context means that the SPV is unlikely to be adversely affected by a bankruptcy of the originator.

In securitisation, the originator partly "deconstructs" itself by separating certain types of excellent quality assets from the risks generally associated with the originator. It can then use those assets to raise funds in the capital markets at a lower cost than it, with its associated risks, could have raised the funds directly by issuing more debt or equity. The originator retains the savings generated by these lower costs, while investors in the securitised assets benefit by holding investments with lower risk.

The major difference between Islamic securities and the traditional conventional ones is the element of *Shari'ah* compliance. Although they share a similar process, structure, and end result, there are a few key principles that must be adhered to in order for these securities to pass the *Shari'ah*-compliance test. These include, for example, the prohibition of interest, the inability to engage in excessive speculation or risk taking, limitations on the use of the sale of financial assets and their use as collateral, and the exclusion of certain industries, like those involving alcohol, gambling, or pork. In particular, while the underlying assets in conventional securitisations are predominantly financial assets, because of *Shari'ah* prohibitions on trading in debt, the underlying assets in *sukuk* securitisations are predominantly non-financial (see Exhibit 17.7).

One of the major areas of concern for Islamic financial institutions relates to the acceptability of the securitisation business (i.e., the content of

EXHIBIT 17.7 *Sukuk* versus Conventional Bond

Parameter	*Sukuk*	Conventional Bond
Issuer	A *sukuk* issuer shall be engaged in *Shari'ah*-compliant business activities.	An issuer of conventional bonds is not limited in its business activities.
Investor base	Enjoys a wider investor base from both Islamic and conventional investors.	Conventional bonds can only tap conventional investors.
Ownership	Investors take direct or beneficial ownership of an underlying asset or pool of assets.	A conventional bond is purely the financial debt of the issuer.
Administrative cost	Additional fees in terms of legal and *Shari'ah* advisory fee.	No additional administrative costs associated with conventional bond issues.
Financing cost	A larger pool of *sukuk* investors creates more demand, hence may help to achieve slightly more competitive pricing.	A comparatively smaller pool of conventional bond investors suggests that there is less demand for the instrument.

Source: HSBC Amanah, KFHR.

the "pool of assets" rather than the actual process of pooling those assets). Islamic financial institutions tend to ensure that each and every asset in the pool is *Shari'ah* complaint. Since the concern is for the nature of each asset on its own and not for the pool as a whole, most commonly securitised Western assets may not be acceptable for a *Shari'ah*-compliant securitisation. The assets in Western securitised pools are invariably interest-bearing debt instruments, such as credit card receivables, mortgages, car loans, and so forth, which are unacceptable to investors seeking *Shari'ah*-compliant investment. It is therefore important for Islamic financial institutions to concentrate on originating their own *Shari'ah*-compliant assets, which may include leasing, equity (partnership) contracts and *murabahah* contracts. In most jurisdictions, however, *murabahah* contracts are non-tradable because of the *Shari'ah* prohibition on trading in debt.

The basic principles that must be adhered to when originating and structuring Islamic securities include:

- Funds raised through securitisation must be utilised for only *Shari'ah*-compliant purposes.
- All credit enhancement features must be structured in a permissible form.

- Most jurisdictions require that the majority of the pooled assets must be nonfinancial assets in order for the securities to be freely traded on the secondary market. Permitted percentages of financial assets range from 30 to 49 percent, depending on the jurisdiction.
- Assets should not be associated with unethical or exploitative operations or with speculation and uncertainty (*gharar*) from nonproductive investments.
- A sufficient element of ownership must be conveyed to investors.

Having stated the above, the Islamic securitisation market has had its fair share of controversy in recent years. In early 2008, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) issued a pronouncement whereby they stated that the majority of Islamic securities (or *sukuk*) did not actually conform to the requirements of the *Shari'ah*. Their points of criticism were focussed around securities that were structured under the *musharakah* and *mudharabah* contracts (profit- and loss-sharing ventures) which included a purchase undertaking over the invested asset portfolio to repurchase it at the issue price, thereby violating the *Shari'ah* requirement that return should be associated with exposure to risk (in effect, such an undertaking may be considered to turn the structure into a type of debt contract).

Nevertheless, the market has yet to fully incorporate the comments into the various *sukuk* transactions due to the lack of better, more viable alternative structures.

In brief, Islamic securitisation is more prudent and less aggressive than conventional securitisation because of the risk sharing principles laid down under Islamic financing principles. *Shari'ah*-compliant securitisation is likely to increase the availability of capital and reduce financing costs for originators and restock the funding sources for institutions; it will provide investors the option of tailor-made products that meet their portfolio requirements, including diversification and risk reduction.

The combination of securitisation techniques with credit derivatives and risk transfer devices allows various market participants to develop innovative methods of transforming risk and to tap into sectors that were otherwise not open to them.

3. MARKET FOR SECURITISATION IN ISLAMIC FINANCE

The use of *sukuk* and asset securitisations to access the financing side of Western capital markets, and as a backbone element in the development of Islamic capital markets, is still one of the fastest growing areas in Islamic

finance. Islamic securitisation is so far growing and expected to grow on an increased basis in many countries, in particular the Gulf Cooperative Council (GCC) and Asian countries, as can be seen in Exhibit 17.8.

The number of active locations involved in Islamic securitisation is increasing significantly every year, and at the end of 2011 this reached 22 different destinations, including both Muslim and non-Muslim countries. The main challenge for potential issuers unfamiliar with Islamic principles is to find and allocate appropriate assets that comply with *Shari'ah* for the securitisation. For the likes of Islamic financial institutions (IFIs) and other financial service sector players, it is fairly straightforward to gather assets that could be securitised due to their entire operations and portfolios being in compliance with *Shari'ah*. The most securitised assets are residential mortgages, as well as auto financing and consumer finance. However, it is expected that the types of assets that will be securitised will become more diversified in the future when the growing market becomes used to the mechanisms and structures.

In recent years, Islamic securities have been structured utilising major infrastructure projects as underlying assets, giving investors beneficial ownership and entitling them to the underlying revenues or cash flows from the project. This has proven to be a successful model of connecting the financial services sector to the real economy without the downside risks of conventional financial assets. A number of benefits can be drawn from this observation:

- Funds are channelled to productive and beneficial projects in the real economy.
- Increased ratings compared to issuer standalone rating due to bankruptcy remoteness.
- Strength of underlying asset base.
- Similar risk/return profile to conventional papers.
- Increased investor base to both conventional and Islamic investors.
- Lower costs.
- Better liquidity (currently confined to emerging Islamic countries with a thriving *sukuk* market).

As such, *sukuk* or Islamic securitisation has proven to be a viable solution for infrastructure and project financing in developing markets, which could be further promoted in developed markets such as the United States, where infrastructure spending is becoming an increasing necessity. Such financing instruments may also attract flush Middle Eastern and Asian investors, as well as sovereign wealth funds looking to invest according to Islamic principles.

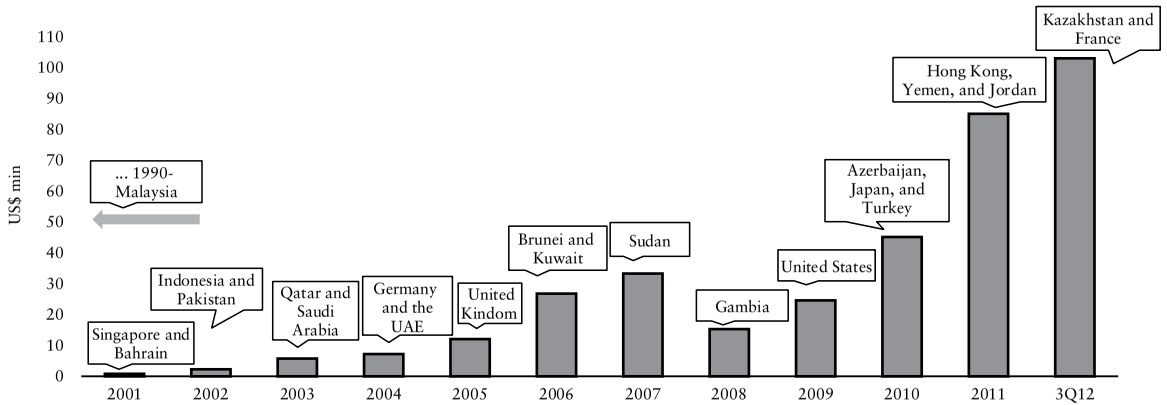


EXHIBIT 17.8 Sukuk Market: Global Market Growth

Source: IFIS, Bloomberg, Zawya, KFHR.

4. SECURITISATION STRUCTURES

The various structures used in Islamic securitisation are either asset backed or asset based. To date, apart from a number of sovereign *sukuk* issuances by the Central Bank of Bahrain, only a handful of successful asset-backed Islamic securities have been issued around the world, as shown in Exhibit 17.9.

There are two types of classifications under asset-backed *sukuk* (these refer to the issuer-SPV, not to the underlying assets):

1. Partnership-based
   - *musharakah*
   - *mudharabah*
2. Agency-based
   - *wakalah bi istithmar*

Each structure typically shares features that are shown in Exhibit 17.10.

However, Islamic securitisation utilises the asset-based approach for the vast majority of transactions, and this has become an increasingly popular and more flexible means to securitise assets. Structures based on Islamic concepts such as *ijarah*, *musharakah*, *mudharabah*, and *istisna'a* have been introduced and are gaining popularity. Most of the *sukuk* issuances to date have been *ijarah sukuk* as well as *murabahah sukuk*, largely based on the nature of the assets underlying the structures. The *ijarah sukuk* securitisation model also has similar cash flow structures to the conventional securitisation structures, which makes investor education far more effortless and swifter to market.

4.1 *Ijarah Sukuk*

Ijarah sukuk is commonly used for project financing. It is a leasing structure coupled with a right available to the lessee to purchase the asset at the end of the lease period (similar to a finance lease). The rental rates of return on the *sukuk* can be either fixed or floating, depending on the agreement. Exhibits 17.11 and 17.12 give some examples of successful *ijarah sukuk* issuances.

4.2 *Musharakah Sukuk*

Under the *musharakah* partnership structure, pricing could be linked to performance of the underlying assets, rather than benchmark rates, on a profit-and-loss-sharing basis as shown in Exhibit 17.13. Investors could receive profits in excess of their actual investment contribution based on a pre-agreed ratio, but any loss will be shared on the basis of the equity

EXHIBIT 17.9 Selected *Sukuk* Issuance

Date Issued	Issuer	Tenure	Return	Country	Amount	Underlying Asset
9 Oct 2011	Arabian Aramco Total Services Co.	14 years	6M SAIBOR + 95bps	Saudi Arabia	US$1bln	Issuer's rights to the underlying transactions documents to which it has benefit
23 Feb 2011	GovCo Holdings Bhd	10 years	4.45%	Malaysia	MYR1.5bln	*Shari'ah*-compliant commodities
25 May 2011	Sharjah Islamic Bank	5 years	4.715%	UAE	US$400mln	*Sukuk ijarah* assets, investments, and transaction documents
5 Aug 2011	Kencana Petroleum Bhd	5 years	3.90%	Malaysia	MYR500mln	The rights and entitlements under the *mudharabah* venture

Source: KFHR.

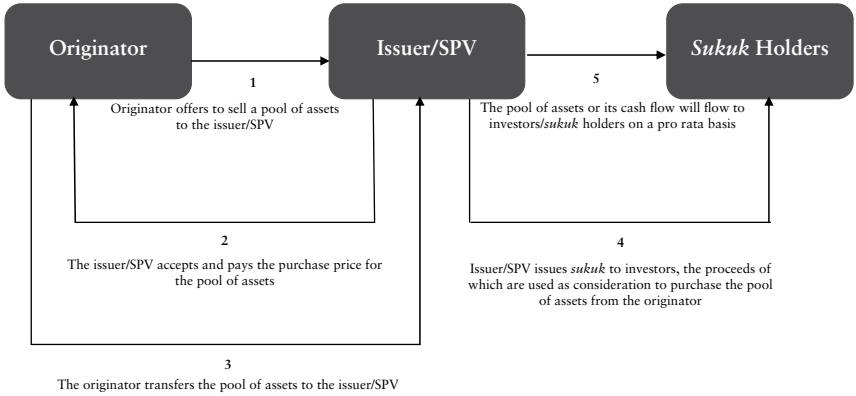

Originator
Issuer/SPV
Sukuk Holders
1
Originator offers to sell a pool of assets to the issuer/SPV
5
The pool of assets or its cash flow will flow to investors/*sukuk* holders on a pro rata basis
2
The issuer/SPV accepts and pays the purchase price for the pool of assets
4
Issuer/SPV issues *sukuk* to investors, the proceeds of which are used as consideration to purchase the pool of assets from the originator
3
The originator transfers the pool of assets to the issuer/SPV

EXHIBIT 17.10 Islamic Asset-Backed Securities

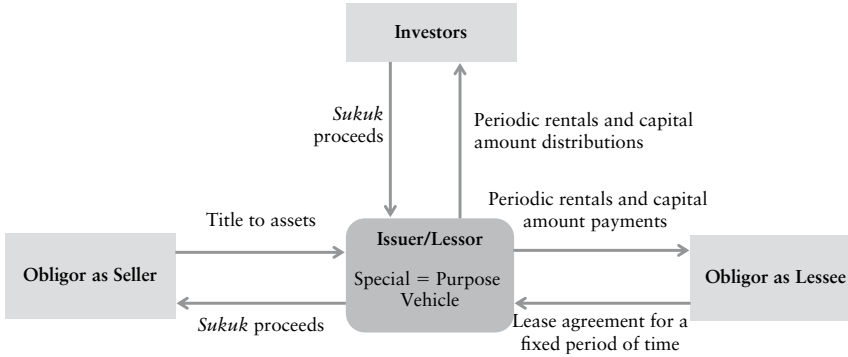


EXHIBIT 17.11 Structure of a Generic *Ijarah Sukuk*

Source: KFHR.

Exhibit 17.12 Selected *Sukuk Ijarah* Issuances

Date Issued	Issuer	Tenure	Return	Country	Amount
30 Nov 2011	ADIB *Sukuk*	5 years	3.78%	UAE	US$500mln
21 Nov 2011	Perusahaan Penerbit SBSN Indonesia II	7 years	4.0%	Indonesia	US$1bln
3 Feb 2011	Emaar	5 years	8.55%	UAE	US$500mln

Source: KFHR.

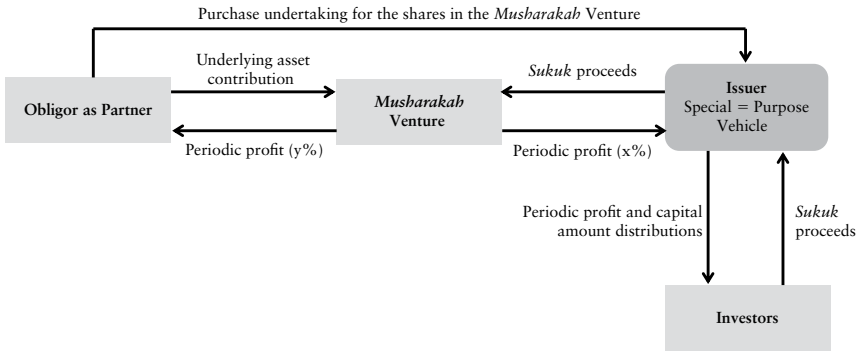


EXHIBIT 17.13 Structure of a Generic *Musharakah Sukuk*
Source: KFHR.

EXHIBIT 17.14 Selected *Sukuk Musharakah* Issuances

Date Issued	Issuer	Tenure	Return	Country	Amount
12 Jan 2012	PLUS Bhd	26 years	5.0%	Malaysia	US$1.7bln
30 Sep 2011	AmIslamic Bank	10 years	4.4%	Malaysia	MYR600mln
23 Jun 2011	Sarawak Energy	15 years	5.65%	Malaysia	MYR800mln

Source: KFHR.

participation. Exhibit 17.14 gives some examples of successful *musharakah sukuk* issuances.

4.3 *Mudharabah Sukuk*

Mudharabah-based *sukuk* is another partnership structure with profit sharing, but in this instance, there is no sharing of losses, as shown in Exhibit 17.15. The return to the investors from *mudharabah sukuk* would be higher than that under the *musharakah* structure, as the risk is higher. The return profile would also be smoother, as the profit-sharing payouts would be adjusted in highly profitable years to maintain payouts in less profitable or loss-making years. Exhibit 17.16 gives some examples of successful *mudharabah sukuk* issuances.

4.4 *Istisna'a Sukuk*

This type of *sukuk* is used for financing of green-field infrastructure projects, given that for such projects the underlying assets do not yet exist. Under the

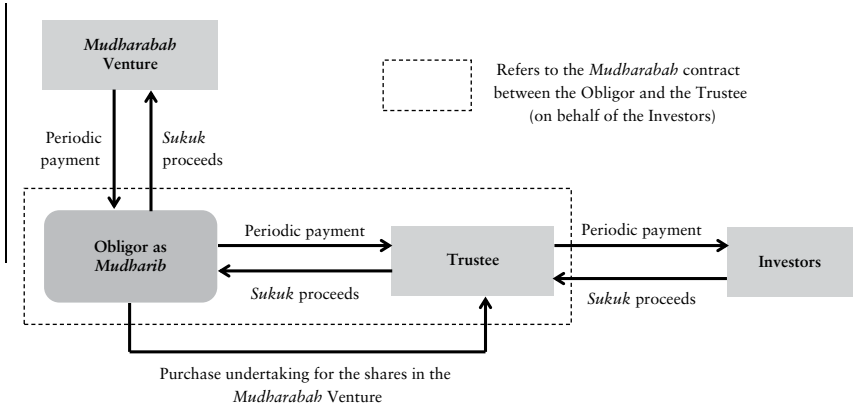


EXHIBIT 17.15 Structure of a Generic *Mudharabah Sukuk*
Source: KFHR.

EXHIBIT 17.16 Selected *Sukuk Mudharabah* Issuances

Date Issued	Issuer	Tenure	Return	Country	Amount
22 Nov 2011	ADCB *Sukuk*	5 years	4.071%	UAE	US$500mln
6 Jul 2011	Sipchem	5 years	3M SIBOR + Margin of 1.75%	Saudi Arabia	SAR1.8bln
24 Feb 2011	Cagamas	4 years	4.05%	Malaysia	MYR400mln

Source: KFHR.

principle of *istisna'a*, the issuer will sell to the financier the identified assets which have yet to be constructed. The financier will then immediately sell back the assets to the issuer based on deferred payment terms, as shown in Exhibit 17.17. Exhibit 17.18 gives some examples of successful *istisna'a sukuk* issuances.

4.5 *Al-Istithmar Sukuk*

This type of structure is used for direct investments in a bundle of assets, which make it hybrid in nature. The underlying assets will combine both financial assets such as *murabahah* receivables with tangible assets such as *ijarah* lease rentals in a ratio of 70:30 respectively. They are asset-based *sukuk* and are usually traded in the secondary market. A diagram of a generic *al-istithmar sukuk* can be seen in Exhibit 17.19. Exhibit 17.20 gives some examples of successful *istithmar sukuk* issuances.

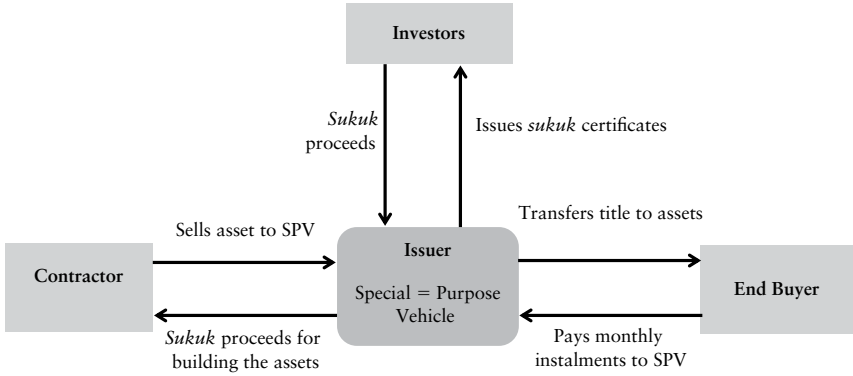


EXHIBIT 17.17 Structure of a Generic *Istisna'a Sukuk*

Source: KFHR.

Note: Completed property / project is leased or sold to the end buyer. The end buyer pays monthly instalments to the SPV. The returns are distributed among the *sukuk* holders.

EXHIBIT 17.18 Selected *Sukuk Istisna'a* Issuances

Date Issued	Issuer	Tenure	Return	Country	Amount
12 Jun 2007	Lebuhraya Kajang-Seremban	18 years	2.0% to 5.8%	Malaysia	MYR1428mln
24 Dec 2007	Mukah Power Generation	15 years	7.4% to 12.5%	Malaysia	MYR85mln
23 Jul 2007	Dynamic Communication Link	1.5 years	6%	Malaysia	MYR10mln

Source: KFHR.

4.6 *Wakalah Sukuk*

AAOIFI defined these as certificates that represent a project or a particular activity carried out according to the *wakalah* principle, where a *wakil* or a representative is appointed to manage the project on behalf of the *sukuk* holder. As *wakil*, the issuer is entitled to receive a management fee. To generate income, the issuer enters into other contracts, such as *mudharabah* and *ijarah*, with other parties. Proceeds from the *sukuk* issuance will be used by the issuer for investments in particular project based on *Shari'ah* principles, as shown in Exhibit 17.21. Exhibit 17.22 gives some examples of successful *wakalah sukuk* issuances.

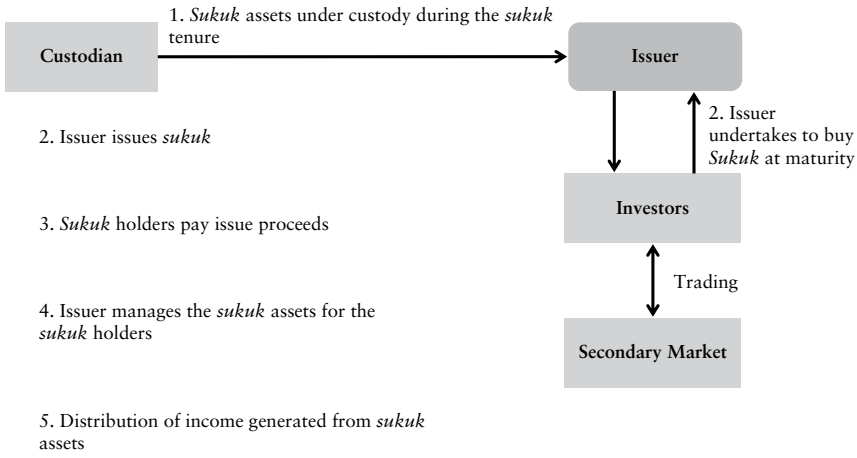

1. Sukuk assets under custody during the sukuk tenure
Custodian
Issuer
2. Issuer issues sukuk
2. Issuer undertakes to buy Sukuk at maturity
Investors
3. Sukuk holders pay issue proceeds
Trading
4. Issuer manages the sukuk assets for the sukuk holders
Secondary Market
5. Distribution of income generated from sukuk assets

EXHIBIT 17.19 Structure of a Generic *Al-Istithmar Sukuk*

Source: KFHR.

Note: Some jurisdictions impose certain limits on a portfolio for the certificates to be tradable whereby the proportion of the nonfinancial assets has to be more than the receivables. Some *Shari'ah* scholars require the majority portion to be at least 51 percent, and others insist that it should be at least two-thirds of the portfolio.

EXHIBIT 17.20 Selected *Sukuk Istithmar* Issuances

Date Issued	Issuer	Tenure	Return	Country	Amount
3 Aug 2011	Gulf Investment Corporation	5 years	4.9%	Malaysia	MYR750mln
18 Feb 2010	Dar Al-Arkan	5 years	10.75%	Saudi Arabia	US$450mln
23 May 2011	IDB Trust	5 years	2.35%	Saudi Arabia	US$750mln

Source: KFHR.

4.7 *Salam Sukuk*

Salam refers to a sale in which the buyer makes payment in advance, and the delivery of the asset is deferred by the seller, as shown in Exhibit 17.23. *Salam* structures are more popular for short-term financing. Exhibit 17.24 gives some examples of successful *Salam sukuk* issuances.

4.8 *Murabahah Sukuk*

In this case the issuer of the certificate is the seller of the *murabahah* commodity, the subscribers are the buyers of that commodity, and the realised

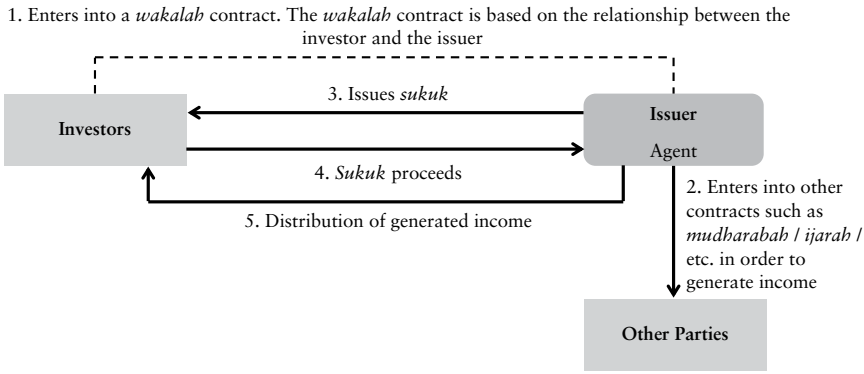

1. Enters into a *wakalah* contract. The *wakalah* contract is based on the relationship between the investor and the issuer
Investors
3. Issues *sukuk*
Issuer
Agent
4. *Sukuk* proceeds
5. Distribution of generated income
2. Enters into other contracts such as *mudharabah* / *ijarah* / etc. in order to generate income
Other Parties

EXHIBIT 17.21 Structure of a Generic *Wakalah Sukuk*

Source: KFHR.

EXHIBIT 17.22 Selected *Sukuk Wakalah* Issuances

Date Issued	Issuer	Tenure	Return	Country	Amount
6 Jul 2011	Wakalah Global	5 years	2.991%	Malaysia	US$1.2bln
11 Aug 2010	Danga Capital	10 years	3.725%	Malaysia	SGD900mln
2 Aug 2011	First Gulf Bank	5 years	3.797%	Malaysia	US$650mln

Source: KFHR.

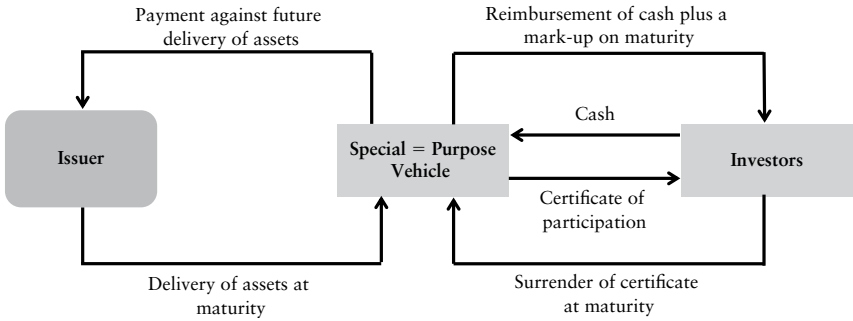


EXHIBIT 17.23 Structure of a Generic *Salam Sukuk*

Source: KFHR.

EXHIBIT 17.24 Selected *Salam Sukuk* Issuances

Date Issued	Issuer	Tenure	Return	Country	Amount
28 Dec 2011	Central Bank of Bahrain	3 months	1.25%	Bahrain	BHD18mln
7 Dec 2011	Central Bank of Gambia	3 months	n.a.	Gambia	GMD25mln
30 Nov 2011	Central Bank of Bahrain	3 months	0.94%	Bahrain	BHD18mln

Source: KFHR.

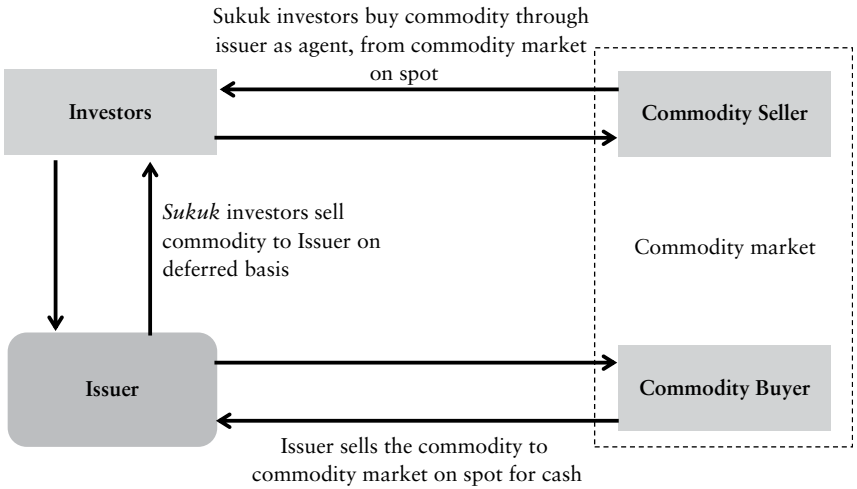

Sukuk investors buy commodity through issuer as agent, from commodity market on spot
Investors
Commodity Seller
Sukuk investors sell commodity to Issuer on deferred basis
Commodity market
Issuer
Commodity Buyer
Issuer sells the commodity to commodity market on spot for cash

EXHIBIT 17.25 Structure of a Generic *Murabahah Sukuk*
Source: KFHR.

funds are the purchasing cost of the commodity, as shown in Exhibit 17.25. The *sukuk* holders own the *murabahah* commodity and are entitled to its final sale price upon the resale of the commodity. Exhibit 17.26 gives some examples of successful *murabahah sukuk* issuances.

5. REGULATORY FRAMEWORK

In many regions of the world, Islamic securities are either self-regulated (under the auspices of the *Shari'ah*) or fall under conventional regulation designed to regulate conventional bonds and other short-term securities. In certain Western developed markets, regulators have amended sections of capital market regulatory framework in order to ensure that Islamic securities would not be disadvantaged in any regards in comparison to

EXHIBIT 17.26 Selected *Murabahah Sukuk* Issuances

Date Issued	Issuer	Tenure	Return	Country	Amount
7 Oct 2010	QIB *Sukuk* Funding	5 years	3.856%	Qatar	US$750mln
2 Jun 2011	HBME *Sukuk*	5 years	3.575%	UAE	US$500mln
17 Dec 2010	Malaysia Airports	12 years	4.68%	Malaysia	MYR1.5bln

Source: KFHR.

conventional instruments. This could be in the form of removing tax hurdles or clarifying the listing process to ensure *Shari'ah* compliance.

Meanwhile in developing Islamic markets, more sophisticated regulation has been developed aimed at incorporating the specific nature of the distinct *Shari'ah*-compliant structures of Islamic securities. Two prime examples are Malaysia and Bahrain, where independent regulation has been developed for the proper oversight of Islamic securities.

Malaysia has been the pioneer in developing regulation for Islamic securitisation, setting an example for other countries wishing to establish or incorporate an Islamic securities market. In 2004, the Securities Commission of Malaysia issued a guideline on the offering of Islamic securities in the country, which outlined the following key aspects:

- The submission of proposals.
- Offering Islamic securities under a self-regulated scheme.
- Documents/information required.
- Eligible persons.
- Appointment of *Shari'ah* advisors.
- Regulatory approvals.
- Rating requirements.
- Underwriting
- Mode of issuance.
- Utilisation of proceeds.
- Additional requirements for Islamic securities programmes.
- Disclosure requirements to investors involving profit/profit and loss sharing elements.
- Time frame for approvals.

Together with other legislation, Malaysia is seen as a well-regulated and transparent market for Islamic securities, as shown in Exhibit 17.27. In fact, the Securities Industry Development Corporation (SIDC), the training and development arm of the Securities Commission Malaysia, has been one of the major training centres for regulators from around the world on implementing a sophisticated and transparent Islamic financial industry.

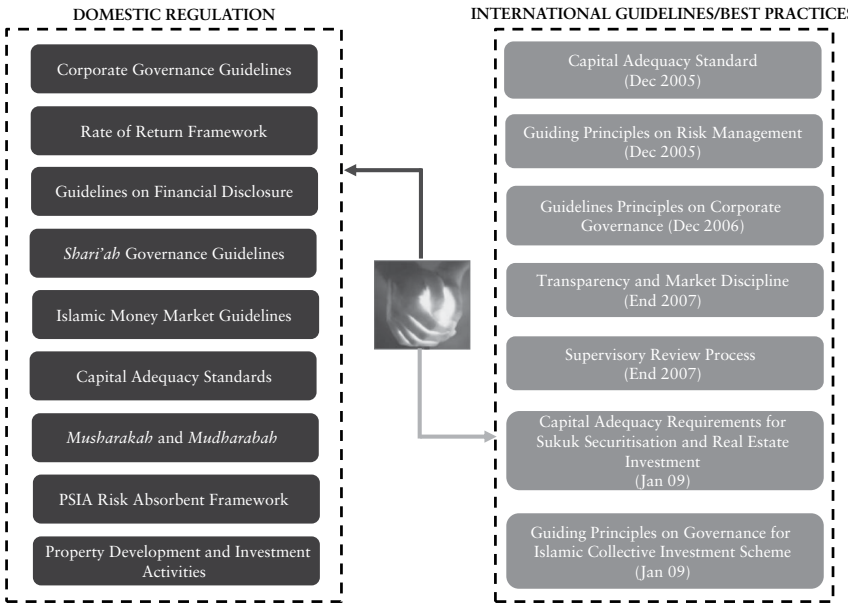

DOMESTIC REGULATION
Corporate Governance Guidelines
Rate of Return Framework
Guidelines on Financial Disclosure
Shari'ah Governance Guidelines
Islamic Money Market Guidelines
Capital Adequacy Standards
Musharakah and *Mudharabah*
PSIA Risk Absorbent Framework
Property Development and Investment Activities
INTERNATIONAL GUIDELINES/BEST PRACTICES
Capital Adequacy Standard (Dec 2005)
Guiding Principles on Risk Management (Dec 2005)
Guidelines Principles on Corporate Governance (Dec 2006)
Transparency and Market Discipline (End 2007)
Supervisory Review Process (End 2007)
Capital Adequacy Requirements for Sukuk Securitisation and Real Estate Investment (Jan 09)
Guiding Principles on Governance for Islamic Collective Investment Scheme (Jan 09)

EXHIBIT 17.27 Malaysian Regulation Initiatives
Source: KFHR.

Bahrain, among a few other countries, requires adherence to the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) standards, which are enforced by the Central Bank of Bahrain, Bahrain's regulatory body for the financial services industry. AAOIFI issued its first standard on Islamic securities in 2002, one year after the first *sukuk* issuance in the country. AAOIFI was established in 1990 by a number of Islamic financial institutions together with the Islamic Development Bank, which spearheaded its establishment. AAOIFI has issued numerous *Shari'ah* standards aimed at clarifying the methods of issuing and investing in Islamic securities.

Other Arab and Muslim countries stand out for their industry-driven approach to Islamic finance as opposed to high dependence on a regulator-led model, as is the case in Malaysia and Bahrain. While the former approach has promoted real progress in attracting global players, there are concerns regarding a lack of core regulatory infrastructure development. For instance, some Arab and Muslim countries do not have a specific Islamic finance policy for regulators or laws mandating *Shari'ah* compliance or regulation specifically promulgated for the Islamic finance industry, nor have they adopted banking regulations specifically developed for Islamic

banks. As such, Islamic banks are regulated and supervised in the same way as traditional banks on conventional prudential regulatory frameworks. Exceptions include the United Arab Emirates (UAE) and Bahrain, both of which have pursued Islamic finance as a niche segment in their economic diversification strategy and are now home to the largest concentration of Islamic finance assets. Both have strived to become regional financial centres, keeping their markets open to foreign banks.

In the GCC countries in general, regulatory and supervisory authorities have adopted the approach that the role of government and supervisory authorities is not to shape evolution and development of Islamic finance by imposing their will and dictating their views, but rather to conduct extensive consultations with the industry and facilitate evolution and development by creating a healthy competitive environment for all participants. However, the approach adopted by Saudi Arabia is somewhat different. While respecting that Islamic finance has some specific and unique features, Islamic banks are viewed as generally exposed to the same types of risks as a conventional bank. Thus, as in other Arab and Muslim countries, the same regulatory approach has been adopted towards Islamic and conventional banks.

The Islamic Financial Services Board (IFSB), which was set up in 2002, has issued a number of international prudential standards and guidelines for Islamic financial institutions. In common with other international standard-setters, the IFSB has no enforcement powers, which are the prerogative of national regulators and supervisors.

The most important challenges in the areas of regulation, supervision, and international harmonisation that are hindering the faster growth of Islamic securitisation include the following.

The multiplicity of *Shari'ah* boards and judgments across jurisdictions impede the homogeneity of products, and create uncertainty for clients and investors about the cross-border acceptability of *Shari'ah* rulings. While Islamic finance is becoming increasingly internationalised, it remains a collection of segmented, weakly coordinated local operations. Since the industry has a great potential to facilitate cross-border capital flows and financial integration, efforts are needed to resolve or at least mitigate the uncertainty regarding the acceptance of *Shari'ah* rulings. This entails more international cooperation on the part of home and host regulators and standard-setters.

The legal and regulatory framework of Islamic finance needs further work to make it consistent with international practices, while maintaining the unique features of Islamic finance and not compromising *Shari'ah* principles.

As in conventional finance, there needs to be an integrated crisis management framework in Islamic finance to ensure that any emerging crisis in the Islamic financial system will be adequately managed. Such a framework

involves having the mechanism and vehicle to address short-term liquidity problems, removing troubled assets from the balance sheets of financial institutions and resolving solvency issues in Islamic financial institutions. Having an adequate crisis management framework also raises the issue of designing *Shari'ah*-compliant deposit insurance systems.

Consumer protection and financial literacy in Islamic finance is an emerging area for regulators.

6. SECURITISATION: A GROWTH DRIVER FOR ISLAMIC FINANCE

As at year-end 2011, *sukuk* issuances soared by 90.2 percent year-on-year from US$45.1 billion in 2010 to US$85 billion, underpinned by the following factors:

- The implementation of the financial masterplans and government initiatives which will act as the backbone of growth throughout the coming years.
- Increase in sovereign issuers utilising the *sukuk* market for monetary policy and fiscal management purposes.
- Economic growth and development in emerging markets. Despite the IMF revising world GDP growth to 4.0 percent for 2011 from 4.3 percent (2010: 4.6 percent), Asia, the Middle East, and other emerging markets are still expected to outperform with 6.4 percent growth in 2011.

Although *sukuk* yields have surged recently due to a downturn in investor confidence, they still remain below the trailing three year average. This had encouraged a number of corporate issuers to deliberate possible *sukuk* issuances in anticipation of executing the deals at the most beneficial timing.

Sukuk showed strong resilience in spite of the Middle East uprisings, leading to a more than threefold year-on-year jump in issuance in the Middle East and North Africa as issuers took advantage of cheaper costs of raising funds.

Based on the issuance momentum seen in 2011, the global *sukuk* issuance for 2012 is expected to show strong growth of 25–30 percent, characterised by the following:

The 2012 *sukuk* market will be driven by global economic activities, accommodative monetary policies, continued sovereign fundraising to support economic growth, as well as the revival of private sector projects. The IMF projects world GDP growth to remain at 4.0 percent for 2012, supported by strong growth in Asia, the Middle East, and other emerging

markets. This will ensure the revival of infrastructure projects on both the conventional and Islamic capital markets.

More sovereign issuers are anticipated to tap the *sukuk* market in 2012 as governments will continue to raise funds to support economic growth and fund fiscal deficits.

New emerging market players as well as new non-Islamic issuers are expected to tap the *sukuk* market.

Increasing demand and popularity for *Shari'ah*-compliant products and structures post–global financial crisis will form a strong demand base for *sukuk* moving forward.

Initiatives taken by various jurisdictions in developing legislative and regulatory frameworks, as part of efforts to attract foreign investments, would allow these new players to explore the *sukuk* industry for the first time.

A number of new jurisdictions have shown interest in issuing *sukuk*, such as Egypt, Senegal, and Nigeria while France, Japan, and Hong Kong continue to make regulatory inroads for future issuances.

The demand for *sukuk* was previously limited outside Asia and the GCC until a few years ago. Potential new *sukuk* markets that will emerge in 2012 include Oman, Thailand, and the Commonwealth of Independent States (CIS) countries. Elsewhere, non-Muslim Western financial institutions and corporates in the United States, United Kingdom, the Europen Union and Central Europe are also becoming more actively involved in this industry, and are interested in issuing *sukuk* to refinance existing corporate debt or to finance working capital and expansion activities, including acquisitions. As in the year 2011, we expect new issuances in 2012 to be dominated by government institutions and the construction and financial services industries.

In light of current economic conditions, investors are expected to seek new forms of funding as well as to diversify from traditional asset classes to tap the capital markets for liquidity. This is expected to create a whole new ballgame for *sukuk* structures and issuances, creating the impetus for innovation within the Islamic finance industry. There is currently a lack of products in the market that can translate across borders into jurisdictions with varying requirements. To achieve internationalisation of the *sukuk* market and boost cross-border financing, this requires more sophisticated products with a mixture of principles involved to adapt across borders. In this regard, the GCC, despite its relative structural and regulatory prudence compared to the world's largest *sukuk* issuer, Malaysia, is perhaps the region creating the most impetus on the innovation front. Earlier this year, the GCC saw an issuance of a multisource deal incorporating a *Shari'ah* tranche, which looked at monetising receipts of the toll road system in Dubai.

In summary, prospects for the *sukuk*-led securitisation industry are expected to remain bright. Having grown at a CAGR of 57.0 percent over the past decade, the *sukuk* industry is expected to exceed the US$130.0 billion mark as at the end of 2012 (2011:US$85.1 billion), and could potentially exceed the US$169.0 billion mark by year-end 2013. Risks to the *sukuk* market moving forward include the fiscal woes of the European countries, which have no clear-cut solutions in sight; the persistent deficit of quality papers; and the lack of an application of *Shari'ah* principles to suit the growing demand of project-based financing needs in the Middle East and Asia.

CHAPTER 18

The Role of Capital Markets in Providing *Shari'ah*-Compliant Liquidity

Prasanna Seshachellam

The effectiveness of any capital market, including Islamic capital markets, depends to a large extent on its depth and liquidity and the extent to which it can provide liquidity to the constituents of the financial services sector in its economy. Liquidity is the vital lubricant to ensure safe, sound, and efficient operations and sustainable growth of various participants in the Islamic finance industry. Islamic financial institutions are not very different from the conventional financial institutions in this respect, as they share similar obligations towards their clients and counterparties and hence a similar need to manage their risk profiles.

1. LIQUIDITY AND ITS IMPORTANCE TO THE ISLAMIC FINANCIAL SYSTEM

The critical importance of liquidity to sound and efficient functioning of the Islamic finance sector is better appreciated now than in the past, given the lessons learnt from the global financial crisis. Although the Islamic finance sector was not affected to the same extent as the conventional financial system by the global financial crisis, the lessons learnt by the conventional finance industry have highlighted the critical role of adequate liquidity in the overall safety and growth of various constituents of the Islamic finance sector. The need to develop a robust liquidity supply infrastructure has been widely accepted among the leading thinkers of the Islamic finance world as an essential prerequisite for strengthening the stability

Islamic Finance: The New Regulatory Challenge.
Edited by Simon Archer and Rifaat Ahmed Abdel Karim
Copyright © 2013 by John Wiley & Sons Singapore Pte. Ltd.
ISBN: 978-1-118-62897-3

and resilience of the Islamic finance sector. Given their integrating role and capabilities, capital markets are in the best position to provide the required liquidity supply to the broader Islamic finance sector.

Adequate liquidity in the financial system is essential to reduce the cost of intermediation and bring down the cost of capital for the wider economy. Adequate liquidity in Islamic capital markets (ICMs) will also enable Islamic financial institutions (IFIs) to manage their risks effectively by providing a range of funding options and risk management tools. Availability of a strong liquidity supply infrastructure materially enhances the capabilities of IFIs to survive liquidity stresses. Most jurisdictions with potential for growth in Islamic finance lack such a strong liquidity supply system, leaving the IFIs operating in those jurisdictions at a disadvantage.

Essentially, there are two main facets of liquidity required by financial institutions—funding liquidity and asset (or market) liquidity. Funding liquidity refers to the availability of funds for consumers of capital or savings, ranging from borrowers for business, borrowers for investments, issuers of equity capital for business enterprise, and so forth. Asset liquidity refers to the equally important facet of ability to buy or sell assets in their marketplace without material adverse impact on pricing arising only due to the occurrence of the transaction. This essentially means that the markets have to be deep enough, with an adequate number of players with adequate financial capacity, so that any desired trade can be executed successfully and in particular without causing a material impact on the pricing. Lack of adequate liquidity in asset markets would result in trades affected by inefficiencies in price discovery, wider bid–ask spreads, and higher volatility in prices causing greater uncertainty to the market participants. All of these would contribute to reducing the attractiveness of such illiquid markets to participants.

In the broader financial services sector, almost all the players and market participants are affected by both facets of liquidity—the funding and asset liquidity—the notable exceptions being the entities at both ends of the financial intermediation chain. The savers who supply capital find illiquid markets for their investments unattractive, as they are inefficient in trading and do not provide finer pricing. This affects the investors both during initial investment of their capital and during disposal of their investments to raise cash, whenever required. Similarly, the ultimate users of capital for business or personal needs—industrial corporates or individuals—are affected by illiquidity in markets, which crimps their ability to raise funds for any capital or current expenditure. In the rest of this chapter, we will analyse various aspects of liquidity and their impact on viable operations of financial services in terms of both funding liquidity and asset liquidity.

2. TRADITIONAL ROLE OF CAPITAL MARKETS IN PROVIDING LIQUIDITY TO FINANCIAL SYSTEMS

Capital markets play a crucial role in the sound and efficient functioning of a country's financial system by being the primary provider of liquidity, a vital ingredient for sustainable growth and sound functioning of the financial system. The crucial role of capital markets in providing the essential element of liquidity to any financial system highlights the need for deeper and broader capital markets. The global financial crisis highlighted the critical need for a sound capital market infrastructure that would be capable of meeting the aggregate liquidity needs of a financial system. Capital market infrastructure in this respect refers to a comprehensive set of structural elements, including but not limited to products, players, and market infrastructure.

In general, capital markets refer to the platform that brings together the investors and issuers who are the suppliers and seekers of liquidity and all the enabling infrastructure elements required for effective functioning of that platform. There is ample evidence pointing to the adverse impact of weak or underdeveloped capital markets on the performance and growth capabilities of the financial systems or jurisdictions of which they form part.

The development of deep and liquid capital markets helps reduce reliance on bank financing and leads to greater diversification of the sources of funding for a variety of market participants, from nonbanking financial firms, corporate entities, sovereign, and subsovereign entities. Well-developed capital markets with appropriate elements of market infrastructure attract a wider set of investors and bring more investable resources to the market, by virtue of their ability to provide the best prices and efficient completion of trading processes. As a result, such markets provide higher levels of liquidity and contribute to the sound operation of the financial markets in their country, ultimately leading to a more efficient allocation of resources. For example, reliance on banks for funding may also result in currency and funding mismatches for projects with long gestation periods, which are particularly relevant for infrastructure financing.

Robust capital markets can provide the much-needed source of stability, particularly during periods of financial stress. Deeper and highly evolved capital markets are capable of ensuring liquidity under most scenarios of market stress, thereby enabling market participants and the financial system to continue to perform and carry out their business. Shallow or underdeveloped capital markets often witness bouts of poor liquidity and are unreliable in terms of enabling participants to complete their transactions or fulfil their needs efficiently.

While the mismatches mentioned above are manageable during periods of stable market operation, such mismatches may be aggravated during periods of instability in markets. Hence, there is a need for strengthening capital markets, medium- to long-term debt markets in this case, to provide alternative sources of funding to match the needs of investment projects and to mitigate potential mismatches. In the short-end of the maturity spectrum, the money markets are integral to the safe and sound operations of banks, in providing IFIs with the tools and avenues for managing any funding gaps and for investing their short-term surpluses. The development of capital markets is a challenging process and may take a considerable amount of time.

3. CAPITAL MARKETS—STRUCTURE AND ANALYSIS

A systematic analysis of the contribution of each of the structural elements of a capital market towards ensuring adequate liquidity will enable us to identify the critical success factors for ICMs and the required enhancements in ICMs.

3.1 Suppliers of Liquidity

In the classical context of capital markets, individuals and corporate entities that have investable surpluses bring liquidity to capital markets with their savings available for financing an investment need of some sort. Often, the investable surpluses from savers are brought to the capital markets by financial intermediaries of different kinds, who provide access to capital markets combined with advice on investment options as a service to their investor clients. In addition, the liquidity in capital markets is amplified by the actions of individuals or entities that participate in market activity for a variety of reasons, ranging from mere speculation to systematic exploitation of risk-free profit opportunities, for example, arbitrageurs in stock markets. The financial intermediaries that are referred to include banks, capital market brokers, sponsors of collective investment funds, or other such investment vehicles.

In a similar vein, investors with surpluses and financial intermediaries providing access to them supply liquidity to ICMs, in terms of both funding liquidity and asset liquidity. Investors in ICMs essentially include primary investors, who bring their investable surpluses in search of a stated risk-return trade-off, and financial intermediaries, who provide access to primary investors of different types and sizes. The financial intermediaries are Islamic banks, investment funds of different flavours, brokers who facilitate

execution of investment transactions in *Shari'ah*-compliant securities, and *Shari'ah*-compliant asset managers who manage assets of investors on a fiduciary basis. All of these intermediaries play a crucial role in bringing liquidity from the primary investors onto Islamic capital markets.

Islamic banks perform intermediation in a manner very similar to that of conventional banks, though they differ in terms of the risk-return opportunities they present to their investors. Essentially, Islamic banks end up channelling a sizeable portion of investable savings from their customers onto Islamic capital markets to provide liquidity. Islamic banks contribute to the generation of funding liquidity as they channel investable savings from their customers and generate asset liquidity by participating in secondary-market activities to manage their investment portfolio or to facilitate their client's trading.

Shari'ah-compliant brokers contribute to asset liquidity by providing access to Islamic capital markets and facilitate acquisition or sale of investments by *Shari'ah*-compliant investors. The presence of *Shari'ah*-compliant brokers contributes, though indirectly, to the generation of funding liquidity by giving the investors the confidence that there is adequate means and capabilities to sell and realise the value of their investments without significant transaction costs.

Islamic asset managers and Islamic fund sponsors facilitate the flow of investable surpluses to Islamic capital markets by providing suitable and reliable investment management services and products, including mutual funds. These asset managers do not guarantee the performance of the investments that they recommend to their clients, but they commit to providing fiduciary care and diligence in managing the assets of their customers, as well as leveraging their skills and expertise in identifying investment potential. In some cases, IFIs, particularly banks and brokers, also perform the role of market makers in Islamic capital markets, thereby contributing to the generation of liquidity.

3.2 Demand for Liquidity

The demand for liquidity arises from potential investors looking for liquid *Shari'ah*-compliant securities and various types of IFIs, who face the need to manage liquidity risk arising from their business operations. This also includes corporates from nonfinancial enterprises who are committed to carrying out their business in a *Shari'ah*-compliant manner and hence look for options to meet their liquidity needs from *Shari'ah*-compliant sources. However, in this chapter we are confining our focus primarily to the liquidity needs of *Shari'ah*-compliant financial institutions (IFIs). The liquidity demand from IFIs has increased due to the introduction of Basel III

liquidity rules, which require all financial institutions, including IFIs, to maintain higher levels of liquidity.

Underdeveloped capital markets with poor capacity to provide liquidity to the financial system are often characterised by a narrow investor base and, more particularly, investors with similar risk-return profiles and investment horizons. Such conditions entail investors adopting buy-and-hold strategies with very limited secondary trading, which hampers development of liquidity.

3.3 Structural Factors Essential for Adequate Liquidity

Various segments of capital markets should ideally be endowed with appropriate levels of market depth and liquidity in order to effectively address the divergent liquidity needs of various types of financial institutions and industry participants. The liquidity needs are spread across a range of dimensions, maturity, product type, and size. But the most widely recognised dimension on which capital markets are segregated is the maturity spectrum, with the normal classification being short-, medium-, and long-term markets.

The level of liquidity in any capital market segment is directly dependent on the extent and nature of participation from issuers who demand liquidity and the investors who supply the liquidity for investment in those securities. To attract a wide range of investors and issuers to achieve strong liquidity, it is essential to ensure a robust regulatory framework and a fair price discovery process that builds trust and confidence among issuers and investors. The causes of inadequate growth in capital markets or in some specific segments are often diagnosed as including a relatively underdeveloped regulatory framework, inefficient market infrastructure, and absence of a wide range of instruments.

4. ROLE OF ISLAMIC CAPITAL MARKETS IN PROVIDING LIQUIDITY

The role of the wider capital markets in providing liquidity and funding support to conventional financial institutions of various types, the pivotal nature of that role, and the concomitant benefits to financial institutions in general are equally applicable to ICMs in relation to *Shari'ah*-compliant financial services. The rationale for deep and developed capital markets and the structural elements for driving liquidity as described above are very relevant to ICMs. Therefore, the foregoing discussion about capital markets in general sets the framework for describing the current state of ICMs and analysing their capabilities to provide liquidity to IFIs.

A well-developed ICM would offer several additional benefits for issuers, investors, and other market participants committed to the *Shari'ah*-compliant financial services sector:

- Reduce financing costs for borrowers and helps in more efficient allocation of savings in Islamic finance system.
- Bring a wider set of investment options to facilitate portfolio diversification and help match investment horizons for investors with long-term liabilities.
- Facilitate investment flows by enhancing investor confidence with transparency and market regulations.
- Help achieve improved pricing efficiency with robust disclosure requirements.
- Enable IFIs and other *Shari'ah*-compliant issuers to manage their risk exposures by providing access to risk management tools.

Most of the major Islamic finance markets are in emerging market countries expected to achieve sustainably high economic growth rates over the next few decades. This raises the need for greater local and foreign investments to fuel their high-growth economic engines and specifically to fund large-scale infrastructure projects. Consequently, the size and depth of ICMs in these emerging markets in particular, are expected to grow materially during this high-growth period in order to attract the required investments. In Gulf countries, the demand for capital or funding is supplemented by the demand for *Shari'ah*-compliant securities from investors whose investment outlays have been expanded by sustained high energy prices and resultant generation of investable surpluses over the past few years.

While the strength of the underlying economic need for growth of ICMs is encouraging, the current status of the ICMs leaves much to be desired in terms of their ability to support and facilitate the expected level of growth. The ICMs in many of the countries with a large Islamic finance potential are yet underdeveloped in terms of their size, depth, sophistication, and ultimately their appeal to investors and other market participants. Many of the structural elements of ICMs required to generate liquidity continue to be rudimentary and hence are scarcely liquid. This leads to inefficiencies in funding the Islamic finance sector in the normal course of business, and potential exposure to adverse effects of systemic risk during times of distress. As a result, these markets lag far behind the banking system and the equity market in their countries as a source of funding for economic growth.

Even in developed countries with well-developed capital markets, their ICM segments are yet in a relatively nascent stage and share many of the

characteristics of ICMs in emerging markets. So, in general, the potential of ICMs to attract savings from investors looking for *Shari'ah*-compliant investments remains untapped in almost all the major economies, except in Malaysia. ICMs in general are characterised by a limited supply of quality instruments from issuers and an absence of benchmark-size issues, with small issues hampering the development of liquidity in the secondary markets.

The short-term segments of ICMs are relatively illiquid, primarily owing to the dearth of credible securities or investment products and the absence of effective market infrastructure. Although the lack of adequate market participants for both supply and demand for liquidity can be cited as a reason for the illiquidity, it is a derivative of the two primary reasons mentioned above. Any improvement in terms of products and market infrastructure will lead to increased numbers of market participants and drive liquidity. The short-term Islamic capital markets face a shortage of easy-to-trade investment securities with relatively low credit risk and stable though low returns. The relatively young stage of evolution of the Islamic finance sector, and a tendency to use conventional instruments for short-term markets, have resulted in this situation. The absence of the necessary market infrastructure in terms of trading platforms, reliable clearing and settlement systems, pricing benchmarks, and evolved industry practices, has further aggravated the illiquidity in the short end.

Illiquidity in the market for *Shari'ah*-compliant securities continues to pose major challenges for risk management by IFIs, in general. The particularly high levels of illiquidity in short-term money markets poses a challenge to robust liquidity risk management by IFIs. Availability of a liquid market in *Shari'ah*-compliant securities would allow Islamic banks with surplus liquidity to fund the Islamic banks with liquidity deficits, thereby maintaining an effective market required to promote stability in the system. With a poor supply of liquidity and low volumes in secondary market trading, the market continues to suffer from consequences of trapped liquidity pools, as seen in high transaction costs and pricing inefficiency. The instruments currently used as standard tools for managing short-term liquidity are characterised by structural deficiencies, which preclude wider acceptance as the market grows. These inadequacies result from their design and operational issues, including expensive trades in underlying commodities or metals and their high propensity to suffer operational risk losses.

The problems faced by IFIs due to weak liquidity supply from capital markets is compounded by the fact that in most countries with substantial Islamic finance activity, sovereign debt markets have not yet evolved to an adequate degree, for various reasons. Sovereign debt markets with low risk perception and easy tradability are traditionally seen as instruments that are most amenable to liquidity management purposes in the short-end of the

maturity spectrum. The lack of liquidity in the secondary market for *Shari'ah*-compliant securities is largely due to the buy-and-hold investment strategy adopted by the majority of the investors participating in these markets. The majority of investors participating in current ICMs are essentially long-term investors looking for fixed returns over the long-term, which limits their motivation to participate in secondary market trading.

Issuers in developing markets, which tend to have ICM activity, are not big enough to go in for benchmark-size issues, and that has restricted secondary market liquidity in many ways. These include inability to attract market makers and unavailability of quality issues, both of which may encourage the investors to hold the securities until maturity.

Market infrastructure surrounding the trading of *Shari'ah*-compliant securities is also not sufficiently well developed to promote their liquidity. The trading systems are inadequate in many countries with material presence of IFIs and *Shari'ah*-compliant business. These markets are also often too inefficient to encourage market participants to actively trade *Shari'ah*-compliant securities. For example, some electronic trading platforms do not have a market-making facility, while others are not linked to the clearing and settlement system. In addition, the inefficient price discovery process in many Islamic capital markets makes it difficult for investors to trade *Shari'ah*-compliant securities. These market infrastructure issues are particularly acute in respect of "fixed-income-like" instruments such as *sukuk* in most of the countries.

Other factors that contribute to lower liquidity include a narrow investor base, low market transparency, and a lack of timely information on *Shari'ah*-compliant issues. Liquidity is not only a challenge faced by ICMs in their effective operations, but is an ongoing concern for their sustainable growth.

4.1 Specific Characteristics of the Islamic Finance Industry

The most significant idiosyncrasy of Islamic capital markets is the limitation on trading of debt obligations arising from *Shari'ah* issues. This limitation constrains the tradability of some *sukuk* structures in secondary markets, particularly those *sukuk* in the short-end of the maturity spectrum. Longer-term *sukuk* structures are usually structured to qualify for secondary market trading on a *Shari'ah*-compliant basis. Another characteristic peculiar to ICMs, which impacts the level of liquidity, is the need to cover *Shari'ah*-compliance issues as part of the disclosure requirements for the products.

The acceptance of short selling in Islamic capital markets is under doubt, which limits its role in driving trading liquidity. Innovation in developing *Shari'ah*-compliant structures to enable short selling for hedging purposes is

required to achieve the contribution towards liquidity. This aspect is particularly relevant to improving asset liquidity levels in equity capital markets, which is essential for improved portfolio management and risk management by various participants in the *Shari'ah*-compliant financial services sector.

5. ENHANCEMENTS TO THE CRITICAL DIMENSIONS OF ICM TO IMPROVE ITS ABILITY TO PROVIDE LIQUIDITY

A detailed analysis of the structural components of capital markets and their ability to support growth and liquidity sets out the key dimensions to assess the ICMs and to identify the areas that need improvements. The primary developments required to improve ICMs in general (and specifically to improve their ability to provide liquidity) include, but are not limited to, a robust and wide suite of credible *Shari'ah*-compliant products, stronger market infrastructure, measures to attract a wider set of investors, steps to reduce uncertainty on market practices and instruments, and efforts to achieve a robust and reliable regulatory framework. It is worthwhile to emphasize here that these elements mutually reinforce their intended impact on improving the overall strength of ICMs. For example, measures to improve efficiency in market operations are also likely to contribute materially to attracting new, uninitiated investors from conventional market segments to ICMs. The International Organization of Securities Commissions (IOSCO), as part of its work on ICMs, has identified the key drivers for enhancing liquidity in ICMs as a wide range of products, lower transaction costs, development of professional expertise in markets, strong regulatory framework, consistent and predictable *Shari'ah* compliance, *Shari'ah* convergence across national markets, and investor education.

The following sections focus on elaborating the extent and nature of improvements required in respect of each of these issues.

6. PRODUCTS

The availability of a strong and wide range of *Shari'ah*-compliant products is a fundamental prerequisite for healthy growth and adequate levels of liquidity in Islamic capital markets. The introduction of a wide range of investment products and material benchmark-size issues from different categories of issuers will support the establishment of a viable and liquid secondary market in *Shari'ah*-compliant investments. It is also essential that the investment products are credible and reliable in terms of consistently delivering the risk-return profile they promise to the investors. To achieve

this, it is essential to achieve a high level of standardisation, to implement regulatory standards requiring better disclosures, and to introduce measures to minimise uncertainty in legal and *Shari'ah* aspects. A wider range of products is also a significant attraction for new market participants, thus indirectly deepening market liquidity.

In this section, we try to assess the various key-product and business segments that create the demand for and supply of various products in Islamic capital markets, in terms of their ability to contribute to market liquidity.

6.1 *Sukuk*

Sukuk (the plural of *sakk*, meaning "certificate") are financial instruments representing an interest in an underlying asset that can be designed using a range of different structures. In the case of "asset-backed" structures, the interest is a type of ownership interest, while for "asset-based" structures it consists of rights to cash flows from the underlying asset. Given the level of success enjoyed so far, *sukuk* as a product is best positioned to have the maximum impact on growth and generation of liquidity in ICMs.

To realise the potential of *sukuk* in driving growth in ICMs, a few key issues and risks need to be effectively addressed. In the past, *Shari'ah* compliance of some of the *sukuk* structures was put under doubt by *fatawa* from some *Shari'ah* scholars. Uncertainties of this kind around the performance of the investment products are not appreciated by investors and consequently lead to material squeezing of liquidity for the affected securities or class of securities. *Sukuk* structures are the most amenable for various types of issuers of varying credit quality to raise capital for their needs, particularly at medium- to long-term maturities. The initiation of sovereign borrowing programmes by many of the primary Islamic finance markets like Kingdom of Saudi Arabia (KSA) and the United Arab Emirates (UAE) is a positive development in terms of widening the product range available to attract investable capital.

6.2 Infrastructure Financing

The importance of developing credible Islamic finance products in this segment is underlined by the need to attract investable resources to finance the rapacious demand from the infrastructure sector, given the rapid growth outlook for infrastructure in most of the emerging markets. This argument is particularly relevant to almost all the key Islamic finance markets, where infrastructure demand will continue to be driven by sharp growth in population and high levels of economic growth. More importantly, the risk-return profile and specific characteristics of infrastructure financing closely match that offered by the fundamental Islamic finance concepts.

The emphasis on asset-backed or -based financing, risk-sharing, focus on equity or partnership modes, and absence of exposure to structural interest rate risk are the main concepts of Islamic finance, which endear it to infrastructure financing. The congruence in key concepts and the wider ideological emphasis on socially responsible investments makes infrastructure financing a suitable business opportunity for the Islamic finance sector. However, the share of Islamic finance in funding infrastructure projects in the past has been very low, particularly compared to the potential available. The reluctance of Islamic financial institutions of various kinds to participate in infrastructure financing deals is primarily caused by the paucity of credible products and *Shari'ah*-compliant market participants who will be interested in participating in such deals. These factors are accompanied by relatively under-developed market infrastructure elements in causing asset liquidity issues in secondary markets for those investments.

In a large majority of the structures, the future return flows can be securitised and traded at negotiable prices, as long as they are structured to represent the returns from physical assets backing them. The most appropriate form of Islamic financing for infrastructure projects is issuance of *sukuk*. The different types of *sukuk* that can be effectively used to finance infrastructure projects while contributing the overall liquidity of long-term segments of ICMs are asset-backed *sukuk*, which are issued against physical assets or their usufruct, and equity-based *sukuk*, which are based on profit- or output-sharing contracts. The latter may also be structured so as to be asset-backed, where the underlying assets might be, for example, the royalties from mineral or hydrocarbon extraction.

6.3 Asset-Backed by, or Asset-Based on, *Mudarabah* or *Musharakah* Contracts

Instruments are based on securitisation of *Shari'ah*-compliant contracts, such as *mudarabah* and *musharakah* partnerships. The underlying asset may be a business venture or an asset, such as an *ijarah* lease or a *murabahah* or *salam* receivable (note that in most jurisdictions the latter are not considered negotiable in secondary markets and so must be held to maturity; hence, they command no liquidity for secondary trading). Even in the case of negotiable instruments, the trading volumes are very thin and hence they do not lend themselves to effective liquidity management by IFIs.

6.4 Risk Management and Hedging Instruments

Shari'ah-compliant hedging instruments, used as part of the primary tool kit for risk management, should form a significant share of the activity in ICM,

as in the case of conventional capital markets. Successful adoption of *Shari'ah*-compliant hedging instruments is likely to play a big part in driving liquidity in various segments of Islamic capital markets. The growth of these instruments implies a growing presence of market makers or dealers, which are the financial institutions producing these instruments. Such financial institutions would face the need to hedge the exposures they assumed while producing these instruments by seeking counterparties with opposite exposures, or by packaging the risks and selling them to an entity that can absorb such risks. Either of these approaches would result in additional liquidity to capital markets in general.

Islamic financing structures are seen by issuers as more complex and consequently more expensive to execute. Often, lack of depth in Islamic capital markets is cited as a reason for the relative distaste for *sukuk* among issuers. This apparent conundrum can be clarified with the systematic assessment of ICMs using the essential building blocks as outlined previously. A lack of reliable products that deliver the promised risk-return profile without any uncertainty in their performance is one of the fundamental issues facing Islamic capital markets. In the case of *sukuk*, the uncertainties associated with their tradability and liquidity have hampered their emergence as a successful benchmark financing structure and have consequently hindered their ability to drive liquidity growth in ICMs.

In addition, the questions surrounding the enforceability of *Shari'ah*-compliant contracts in jurisdictions that do not have supporting *Shari'ah* law also give rise to indifference among potential issuers and/or bankers. The primary uncertainty in this regard includes varying *Shari'ah* interpretations of scholars within and across national boundaries as well as over time. It is essential to work towards convergence of *Shari'ah* standards and interpretations to ensure reliable products for investors in Islamic capital markets across national jurisdictions.

Apart from idiosyncratic elements of each of these products, a steady stream of primary issues of products, sprinkled with adequate levels of benchmark size issues, is essential for achieving a deep and liquid secondary market. There is a need for *sukuk* and other types of *Shari'ah*-compliant investments of varying tenors from 3 months to 30 years, all of which can together form a benchmark yield curve, for issuers of a specific risk level. The developments in sovereign *sukuk* markets are encouraging in terms of providing the necessary elements to form a benchmark sovereign yield curve. In this regard, it is essential to understand the importance of other factors, like legal and regulatory frameworks, to attract adequate numbers of issuers, and a market infrastructure to be able to handle the resultant volumes.

7. PLAYERS

Islamic capital markets also suffer from inadequate depth and diversity of market participants. This is equally applicable to investors of various types who bring investable savings to the market and for intermediaries who are in the market, as part of performing various roles in the Islamic financial services industry. Given the emerging nature of the Islamic finance industry, the number and range of participants is limited in every segment of the ICMs. The issue is exacerbated by the early stage of development of the financial sector in most of the dominant Islamic finance markets, like those in Middle East.

The absence of a range of market participants with differing risk-return profiles is a material limitation on the attractiveness of ICMs as source of funding liquidity for issuers and projects, particularly those with unique risk-return profiles. ICMs lack a diverse set of market participants who are differentiated by the normal range of tenor in which they seek or deploy their funds. For example, the absence of adequate number of pension funds and family-*takaful* companies results in a reduced appetite for long-term financing instruments and consequently limits funding liquidity in long-term markets, which provide financing for infrastructure projects.

The issue is particularly worrying in the case of long-term capital markets and infrastructure financing. Liquidity in ICMs and specifically in equity and long-term segments is limited by an inadequate presence of institutional investors. The *takaful* industry and the *Shari'ah*-compliant asset management industry are yet in early stages of evolution and consequently do not command the capability and expertise to contribute to liquidity growth in ICMs. *Takaful* and pension funds, which are normally expected to generate liquidity at the long end of the maturity spectrum, are yet in the process of evolving, and hence in short supply, in most of the major Islamic finance markets.

Although Islamic banks and investment companies have proliferated, their ability to drive liquidity in their local markets is limited by their size and passive strategies for investment and risk management. Islamic brokerages and investment companies are limited to executing trades for their clients on an agency basis or trading for their own account. But, such firms are rarely involved in making a market for any *Shari'ah*-compliant investments by offering two-way quotes, which is an essential ingredient for higher asset liquidity in secondary markets.

It is important to communicate the various positive developments in the sphere of Islamic capital markets to potential investors and issuers, so as to attract them to participate in Islamic capital markets. Such an effort should

emphasise the asset-based transactions, lack of speculative or risky trades, and rapid growth in capital available for *Shari'ah*-compliant investments.

The ability of various types of Islamic financial institutions to contribute to liquidity in ICMs is further hampered by the lack of skilled and experienced personnel who can develop and implement the active investment or risk management strategies that invariably result in accessing capital markets for execution of such strategies. The absence of an adequate number of skilled personnel also limits the capabilities of investment banking businesses in providing attractive *Shari'ah*-compliant structures for potential issuers, thereby limiting growth in liquidity. Most of the Islamic financial institutions are limited to performing passive buy-and-hold strategies for their investment portfolios, which crimps asset liquidity. This issue is particularly relevant for markets in short-term securities and fixed-income investments.

The contribution of market participants to driving liquidity growth is hampered in many significant Islamic markets by the absence of the government sector's efforts to come to the market with innovative instruments for resource mobilisation. This would provide the market with a wider range of instruments with divergent risk-return profiles, attracting investors looking for such investments. The presence of the government sector not only helps the government at various levels of sovereign, quasi-sovereign, and municipal entities to raise resources for their investment needs, but also provides low-risk investments that can facilitate risk management for IFIs, particularly in the short end of the maturity spectrum.

There is a need to attract investors and issuers who are not mandated to be *Shari'ah*-compliant as part of efforts to deepen Islamic capital markets. The challenges involved in achieving this illustrate the interrelated nature of all the drivers for growth of liquidity in ICMs. It is difficult to attract market participants of all stripes as long as the markets are not deep and liquid, and most of these investors being new to Islamic finance would look for reliable investment products or securities without any uncertainty associated with the investment's risk-return profile.

8. INFRASTRUCTURE

The different components of market infrastructure required to drive trading volumes and liquidity in various segments of Islamic capital markets include regulatory standards, dedicated market places, accounting standards, and standardisation in products and documentation. The most important development in this area relates to development of a viable secondary-market-trading platform, particularly for nonequity investment products.

This will significantly improve the asset liquidity and enable *Shari'ah*-compliant investors to manage their liquidity profile as well as to implement their overall risk management strategies. The supporting infrastructure required for deepening ICMs includes efficient clearing and settlement system and price information providers.

An example of the kind of innovation required to drive asset liquidity within the confines of *Shari'ah* is the development of an Islamic alternative to stock borrowing and lending to facilitate regulated short selling in Malaysia. Innovative facilities like this in the ICMs are often necessary to continue to provide all relevant tools and products for market participants to manage their investments and risk on their portfolios. The alternative to stock borrowing and lending is made possible within the *Shari'ah* framework by rendering the *gharar* (uncertainty) element irrelevant. In respect of standard documentation, the International Islamic Financial Market (IIFM) and the International Securities Dealers' Association (ISDA) are involved in an effort to create a master agreement for *Shari'ah*-compliant securities.

The enhancements required to drive efficiency gains in market operations should broadly include: smooth and reliable legal and regulatory framework for the issue of securities, reducing the time to market; and standardized documentation for the common set of products and functionalities in the market that facilitate accuracy and reliability in pricing. Issuance in securities markets typically involves authorisation by the issuer, documentation process (including prospectus review), registration or approval by the regulator, and offerings to the market, among other factors. This issuance process may prove to be challenging for many issuers, as they may be subject to an onerous and time-consuming issuance process, usually attributable to inefficiencies in the approval framework. For example, multiple authorities may be involved in the registration or approval of the issue, resulting in duplication of processes. These issues are compounded by inadequate proposals or issue documentation from issuers, and probable lack of adequate skills with the regulator. It is imperative, therefore, that the regulatory processes relating to new issues in ICMs are developed adequately to ensure that time to market is optimized, while ensuring compliance with regulations.

The measures aimed at a more robust market infrastructure should include measures to improve trading efficiency in terms of lower trading costs, reduced bid-offer spreads, ensuring availability of adequate market makers, and establishing reliable and accurate pricing benchmarks. A robust market infrastructure should also include various critical infrastructure entities essential for completing pre- and post-trade processes in an efficient manner.

An important enhancement target required is to ensure certainty and to facilitate clarity and understanding on the terms of the product and

assurance that investors will be treated fairly. The key measures to achieve this enhancement should include strengthening legal, regulatory, and supervisory frameworks, robust disclosure standards in terms of their quality and timeliness, and an investor protection framework that infuses confidence in potential investor groups. To address the uncertainties surrounding the treatment of *Shari'ah*-compliant structures based on *Shari'ah* law and to enforce those contracts in a consistent manner, it is essential to establish a legal framework that protects the interests of all stakeholders in a predictable manner.

It is essential to ensure that the markets deliver reliability in price discovery, efficiency in terms of trade execution, and price transparency. In order to achieve the expected improvements cited above, it is not adequate to rest with establishing the relevant and necessary regulations. It is important to ensure that the improvements are actually felt by the investors in their market activities. This can only be achieved by effective implementation of regulatory standards and intensive risk-based surveillance and supervision of the markets. In addition, ancillary factors to be addressed to achieve improvements in widening the investor base include removal of regulatory obstacles, which impede the participation of some groups of investors in Islamic capital markets, and initiatives to reduce uncertainty in relevant tax rules. These improvements would make a big contribution to ensuring predictability in regulations and their implications for transactions.

9. MARKET SEGMENTS

Section 9 analyses the key market segments in Islamic capital markets in respect to their stage of evolution and the enhancement opportunities they present.

9.1 Short-Term Money Markets

One of the crucial lessons learnt from the financial crisis was the shattering of the myth that wholesale short-term funding from interbank markets is reliable. Currently, IFIs are reliant on wholesale markets to a great extent, particularly for their short-term funding needs, given the lack of adequate liquidity supply from capital markets in that segment. In fact, this observation is equally attributed to other segments of the ICM as well.

Short-term segments of ICM are fairly illiquid and have so far failed to serve the interests of the wider Islamic financial services industry in many countries. The critical aspects of short-term Islamic money markets that need to be strengthened to achieve the required level of liquidity include credible

short-term *Shari'ah*-compliant securities and effective infrastructural components of the market. Improvements in these structural aspects of the market segment would attract and retain the interest of a wider section of market participants, both from investors and issuers, irrespective of their proclivity towards religious considerations.

This approach has been successfully employed in Malaysia, which has achieved a high level of success in creating and sustaining a short-term money market in *Shari'ah*-compliant securities. In Malaysia, the Islamic Inter-bank Money Market (IIMM) was introduced as an intermediary structured as a platform offering a range of short-term *Shari'ah*-compliant investment securities. This facilitated the strong growth of the Islamic banking sector in Malaysia by enabling such IFIs to fulfil the funding requirements effectively and efficiently. The IIMM platform included a range of *Shari'ah*-compliant instruments from *mudarabah*-based investment options and bonds, negotiable instruments of deposit, securities issued by Bank Negara Malaysia (the central bank) and Malaysian government, and funds acceptance under *al wadiah* contract and *murabahah*-based bills. The development and growth in activity of the IIMM has been possible due to the active involvement of the Malaysian government and BNM, which is also the lender of last resort. As seen in other segments of the Islamic financial services industry, Malaysia has been fairly innovative in leveraging the various *Shari'ah*-compliant contracts and the underlying *Shari'ah* principles to introduce new products and sustain a high level of liquidity in markets.

9.2 Long-Term Markets

The medium and long-term segments of ICMs are also characterised by the same deficiencies discussed above in the context of short-term ICMs. Although there had been a steady and growing stream of supply of *Shari'ah*-compliant securities in this segment over the past decade, the liquidity in the secondary markets has continued to be poor. This has limited the utility of the available *Shari'ah*-compliant securities in enabling IFIs to effectively manage the risks on their balance sheet. The risks faced by IFIs range from asset–liability mismatches, structural profit rate risk (if any), to credit risk exposures associated with investments on their balance sheet.

Poor liquidity in secondary markets also adversely affects the attractiveness of ICMs as a source for infrastructure financing, though the essential characteristics of Islamic finance make it eminently suitable for infrastructure financing. Given the emphasis on asset-backed or asset-based structures, risk sharing, and the preference for socially responsible investments in the Islamic finance sector, infrastructure financing offers appropriate *Shari'ah*-compliant investment opportunities. A variety of Islamic

contracts are available for primary financing of an infrastructure project, ranging from *istisna'a* to *murabahah*, to provide debt funds for construction of the project. Equity funds are provided by way of *musharakah* or *mudarabah* contracts. In addition to these, *sukuk* of both asset-backed or -based and equity varieties can be used for raising funds for infrastructure financing.

As already noted, *sukuk* structures based on contracts used for debt financing (*murabahah*, *salam*) generally do not provide tradability in secondary markets for reasons of *Shari'ah*–non-compliance. Although *sukuk* based on other forms of contract issued to finance infrastructure projects can be traded in secondary markets, there is in fact very little appetite for doing so. Such *sukuk* are invariably held to maturity and attempts to sell them usually involve material discounts that affect the return proposition on the investment. Absence of deep and liquid markets proves to be a significant deterrent for wide use of *sukuk* in infrastructure financing, thereby failing to connect the suppliers of funds with those in need of funds. This exemplifies the failure of Islamic capital markets in one of their fundamental roles, and hence efforts to bring in liquidity should receive utmost attention in order to maintain the competitiveness of ICMs and to achieve growth. Having emphasized the importance of generating liquidity, it is fair to recognise the fact that generating liquidity in fixed-income markets, including conventional ones, is a tough challenge and has been successfully achieved in very few jurisdictions.

The trading liquidity of *sukuk* has also been adversely affected by uncertainty surrounding their *Shari'ah* compliance. The *Shari'ah* issues that have affected *sukuk* in the past were related to the guarantee of initial capital by originators, buy-back of assets underlying *sukuk* at predetermined selling price, and certain practices of smoothing returns to *sukuk* holders. So, measures to improve the asset liquidity of *sukuks*, particularly in secondary markets, are essential to achieve growth in ICMs and to enhance overall market liquidity. One of the suggested ways is to improve the attractiveness of *sukuk* to investors by including embedded options in *sukuk*, including a convertibility option.

10. CURRENT TRENDS AND WORK IN PROGRESS

In spite of the weak economic growth trends in most of the developed financial markets, inflationary pressures, elevated levels of sovereign risk, and heightened risk aversion among investors, ICMs are expected to witness sharp growth over the medium to long term. This accelerates the need to

establish and implement the structural elements for a robust liquidity supply infrastructure to support the expected growth in Islamic finance activities.

In the short-term market, various key contributors to the growth of Islamic finance are already at work. An evolutionary trend in this area was triggered by the establishment of a high-level taskforce on liquidity management by the IFSB, which was mandated to develop a liquidity infrastructure to facilitate and offer liquidity solutions to IFIs with the objective of supporting their growth and enhancing their liquidity risk management. Successful work by this taskforce has led to the incorporation of the International Islamic Liquidity Corporation (IILM), an international institution dedicated to design, implement and operate an international liquidity management framework for IFIs.

The incorporation of the IILM in October 2010 represented a significant milestone in the development of supporting infrastructure for the global Islamic finance industry. The IILM is expected to play a crucial role in facilitating liquidity management, including for cross-border IFIs. The structure of IILM raises expectations of the effective fulfilment of its objectives, given the close involvement of a group of central banks in its operations. The current members of the IILM include 12 central banks and regulatory authorities, and two multilateral development institutions; membership is open to central banks, financial regulatory authorities, and relevant multilateral organisations.

The IILM is mandated to issue short-dated high-quality *Shari'ah*-compliant financial instruments in major reserve currencies on a regular basis, in a cost efficient manner. The IILM intends to establish a wide array of high-quality *Shari'ah*-compliant instruments as well as a platform to support the issue and trading of those instruments to address the challenges related to liquidity supply in Islamic capital markets and hence to facilitate liquidity management in IFIs.

Shari'ah-compliant instruments issued by the IILM are expected to merit a high credit rating, as they are supported by the credit strength of its shareholders. This should enlarge the pool of instruments that can qualify as collateral for collateralised short-term money market borrowing/lending and for central bank funding. The nature of constitution and the likely high credit quality is likely to enhance the acceptability of IILM's securities for secondary market trading among IFIs within and across different jurisdictions. The IILM is also mandated to make a qualitative contribution to the development of ICMs and their ability to provide liquidity by providing a platform for interaction among its members regarding potential innovations and evolving practices in Islamic liquidity management.

The short-end of Islamic capital markets also saw a notable development in 2011, in the initiation of Islamic Interbank Offer Rate (IIBOR), which is

expected to serve as a benchmark for pricing Islamic finance transactions. The benchmark will provide the reference for pegging the profit rates on transactions and is designed to be determined on the basis of bid-offers provided by a set of 12 large IFIs. The development of such a benchmark is very valuable for growth of the short-term segment in ICMs, given the difficulties and uncertainties faced by IFIs in pricing their transactions with benchmarks, which were seen as potentially *Shari'ah*–non-compliant.

Despite all the issues raised earlier in respect of long-term *Shari'ah*-compliant instruments, their supply continues to grow gradually. In particular, the issuances of *sukuk* from non-Muslim countries like Germany, China, and Japan are attracting rising interest. Quasi-sovereign entities from nontraditional Islamic markets have realised the benefits of accessing ICMs to raise long-term funds. Over the recent past, the asset-backed nature of certain *sukuk* and the relative credit quality of the large corporates issuing *sukuk*, particularly those in GCC countries, have attracted investors in a climate of uncertain credit quality in conventional fixed-income markets. The increasing product supply is complemented by a gradually widening range of investors from insurance companies, pension funds, and long-term savings organisations. The geopolitical trends observed in 2011 in the Middle East/North Africa (MENA) region spurred the policy makers in that region to implement strategies aimed at facilitating long-term savings and ensuring long-term risk cover for their constituents. These strategies have already resulted in initiatives like National Bonds Corporation in the United Arab Emirates, government pension funds for social security measures, and promoting private pension schemes for the welfare of the public. In addition, the improving trend in the quality of risk management employed by financial institutions in major Islamic finance markets, notably insurers, has led to their increasing participation in long-term Islamic capital markets. These trends, on their own and in combination with other initiatives, have contributed immensely to the gradual enhancement of the Islamic capital markets' capability to provide all aspects of liquidity to the wider Islamic financial system.

CHAPTER 19

Regulating the Islamic Capital Market

Nik Ramlah Mahmood

1. INTRODUCTION

In its formative years, the evolution of the Islamic financial services industry was largely driven by the growth of Islamic banking and *takaful* (insurance products based on *Shari'ah* principles). Over the last decade, the emergence of a vibrant Islamic capital market (ICM) in several Muslim countries is a significant milestone that denotes the coming to maturity of the global Islamic financial system. In this context, the growth of the ICM parallels the financial deepening process experienced in many emerging markets, most notably the large developing economies. As a reflection of this trend, the emerging markets' share of global equity market capitalisation rose from 13 percent in 1990 to 24 percent in 2010.

The expanded role of markets in the Islamic financial intermediation process is already providing many benefits in relation to financing investments and catalysing the growth process in many Muslim countries. More importantly, it provides greater opportunities to shift from a developmental process that is based on replicating conventional finance towards an approach that facilitates financing based on structures and services that originate from risk-sharing concepts and that comply with the ethical principles that draw their roots from Islamic theology.

ICM offers a broad range of capital market products and services to meet the needs of issuers and investors, of which the most prominent currently are equities and *sukuk*. More recently, there has been considerable progress in expanding the range of *Shari'ah*-compliant products and services, including collective investment schemes such as unit trust and closed-end funds,

Islamic Finance: The New Regulatory Challenge.
Edited by Simon Archer and Rifaat Ahmed Abdel Karim
Copyright © 2013 by John Wiley & Sons Singapore Pte. Ltd.
ISBN: 978-1-118-62897-3

investment banking, stockbroking, fund management, private equity, and venture capital, as well as funds and wealth management. To address the risk-management needs of banking and *takaful* products and operations, derivatives have also been developed, but their use is restricted for purpose of managing business exposures only.

The regulation of the ICM poses several unique challenges as compared to the regulation of Islamic banking and *takaful*. For example, the traditional products of the banking industry, such as deposits and loans, are effectively direct bilateral contracts between two parties, while capital market products such as *sukuk* and other investment-based products such as exchange traded funds involve standardised contracts, public disclosure of information, and tradability. Arising from this, markets tend to operate in highly unbounded environments and present regulatory challenges beyond credit and prudential risks. Typically, the regulation of markets would incorporate elements such as surveillance of markets and products and more importantly, from a *Shari'ah*-compliance standpoint, behavourial control systems such as for disclosures, conduct, and governance.

Development of new products and variants to product structures are also typically more prevalent within the ICM as compared to Islamic banking and *takaful*, thus requiring greater regulatory monitoring to ensure a sufficient level of investor protection while facilitating orderly growth of the market.

ICM products are also generally becoming more universal in that they are being offered and subscribed to in multiple jurisdictions, for example global *sukuk* and collective investment schemes. Such cross-border transactions and distributions require more intensive scrutiny from a regulatory perspective to address, *inter alia*, jurisdictional differences. This development has in recent years contributed to greater collaboration among regulators in order to mitigate the cross-border-related challenges.

2. THE APPLICABILITY OF UNIVERSAL PRINCIPLES OF SECURITIES REGULATION

Given that markets tend to operate in a more open environment, the fundamental challenge in regulating ICM is whether the objectives and requirements of *Shari'ah* are compatible with the underlying principles of securities regulation. A fact-finding study in 2004 by the International Organization of Securities Commissions (IOSCO)[1] concluded that ICM constitutes a segment of the wider global securities market and therefore its regulation should comply with IOSCO's Objectives and Principles of Securities Regulations (IOSCO Principles), which are intended to:

- Ensure fair and efficient securities markets.
- Protect investors.
- Reduce systemic risk.

According to the IOSCO study, a capital market with a sound regulatory framework and supporting infrastructure must first be present in order to nurture and support an Islamic component; thus ICM products and services may be introduced and developed within any existing well-structured securities market. The study also noted that the conventional securities regulation framework and principles equally apply to the ICM, with the addition of some form of a *Shari'ah* approval or certification process. The study further noted that formulation of separate regulation for the ICM is therefore unnecessary although it recognised that in certain instances individual jurisdictions may see the need for more specific guidelines to be introduced to ensure that the unique aspects of ICM are appropriately regulated.

The 2004 study was revisited by IOSCO in 2008 with the finding that no concerns were identified with respect to the compatibility of the IOSCO Core Principles with the Islamic securities market, although the implementation of the principles could benefit from further consideration in some specific areas.

The experience of several countries, including Malaysia, has borne out the IOSCO findings in that their ICMs do provide investors the same degree of clarity, certainty, and protection as those available in the conventional market. As in conventional capital markets, effective regulation of the ICM involves the effective interplay of regulatory discipline, market discipline, and self-discipline. In this regard, the process of financial deepening requires strong regulatory oversight accompanied by high governance standards to enable self- and market-disciplinary mechanisms to complement regulatory discipline. Regulations play an important role in defining the arrangements that reinforce investor trust and confidence in the markets. Nonetheless, the active involvement of market participants and other stakeholders is required to ensure that governance arrangements are effective and provide social benefits.

3. APPROACHES TO REGULATING ICM

There are various approaches that are adopted in the regulation of ICM. One approach is to limit the scope of compliance with *Shari'ah* or other ICM-specific requirements to being governed only by rules relating to disclosure, false information or misrepresentation, and other applicable existing laws. The drawback to this approach is that where ICM product structures or services do not fall within the realm of existing regulation, then there will be constraints in introducing such new products or services.

Another approach is to introduce changes to existing laws to cater for specific *Shari'ah* requirements or to overlay the regulatory framework with an additional tier of ICM-specific regulations.

In fact, both approaches are complementary and useful in addressing various legal challenges. For instance in Malaysia, prior to 2004, all issuance of private debt securities including *sukuk* (or Islamic securities) was previously regulated under a single set of regulations that was applicable to both conventional and Islamic products, with certain *Shari'ah* requirements embedded specifically to govern the issuance of Islamic securities. However, since the term "debentures" was used, this had the effect that only *sukuk* that fit into the definition of debentures such as the *bai' bithaman ajil*[2] could be introduced. More widely accepted structures—which involve elements of profit and loss sharing (for example *sukuk* structures using principles such as *musharakah*[3] and *mudharabah*,[4] which are based on equity participation)—were inadvertently precluded.

This impediment was remedied in 2004 when the Securities Commission Malaysia decoupled *sukuk* from the definition of debentures and introduced a new legal definition for "Islamic Securities."[5] The 2004 Guidelines on the Offering of Islamic Securities[6] was introduced specifically to facilitate *sukuk* issuance for both debt-based, and participatory or equity-type structures. The 2004 guidelines provided the opportunity to use a wider variety of *Shari'ah* contracts in structuring *sukuk*.

From a policy perspective, Malaysia has implemented a regulatory framework that considers ICM an integral and important segment of its overall capital market with specific regulation introduced to address impediments and gaps, to facilitate innovation, and to ensure as well continuous progress in raising governance and ethical standards. In this regard, the umbrella legislation for the capital market, namely the Capital Markets and Services Act 2007* (CMSA), regulates all activities, markets, and intermediaries in the Malaysian capital markets, and this extends to ICM. The CMSA provides for powers to make ICM-specific regulations—an example of this being the power of the minister to prescribe what are Islamic securities and to modify the provisions of the CMSA in respect of such securities to give effect to the *Shari'ah* (section 316). The CMSA also has specific provisions relating to the Shariah Advisory Council (SAC) for the ICM (sections 316A to 316H).

In this context, issuers of Islamic products must comply with the relevant disclosure requirements such as disclosure relating to prospectuses or trust deeds as expressly set out in sections 232[7] and 258[8]of the CMSA, and in the

*Details and complete texts of the acts and guidelines referred to in this chapter can be found at the websites of the Securities Commission Malaysia (www.sc.com.my) under the "Legislation" column, the Central Bank of Malaysia (www.bnm.gov.my) under the "Law, Policy and Guidelines" column, and the Islamic Financial Services Board (www.ifsb.org).

Prospectus Guidelines dated 8 May 2009, and Trust Deeds Guidelines dated 12 July 2011. Additionally, ICM intermediaries are subject to the same requirements related to their activities—for example, disclosure of interests in the provision of investment advice and the segregation of client monies in trust accounts.

The capital market regulatory framework also extends to include subsidiary legislation, rules, and other legally binding guidelines. In this regard, additional ICM-specific requirements can be introduced in supporting legislation by providing other additional requirements, those applying only to ICM products and services. For instance, Malaysia's Guidelines on Unit Trust Funds (issued on 3 March 2008) contain additional requirements that apply only to Islamic unit trust funds. These requirements include:

- The appointment of a *Shari'ah* adviser to advise on all aspects of unit trust and fund management business in accordance with *Shari'ah* principles.
- Specific reporting requirements by the *Shari'ah* adviser to be included in the fund's annual and interim reports stating its opinion as to whether the fund has been operated and managed in accordance with *Shari'ah* principles for the financial period concerned.
- Appointment of a designated compliance officer.
- Appointment of two Muslims as members of the investment committee.

Yet another approach that can be considered for regulating ICM is to introduce complete stand-alone guidelines for Islamic products or securities. This approach is useful when there are significant differences between the requirements for conventional and for ICM products. Malaysia has taken this approach in regulating other ICM products and services, for example in introducing the Guidelines on Islamic Fund Management dated 3 December 2007, which sets out the *Shari'ah* principles and concepts for an Islamic fund management business. The guidelines also require an Islamic fund manager to maintain all accounts with Islamic financial institutions, or to maintain the accounts in other financial institutions provided they are maintained in accordance with *Shari'ah* principles and to segregate their accounts from those of conventional business.

4. THE *SHARI'AH* GOVERNANCE FRAMEWORK

An effective and robust *Shari'ah* governance framework that ensures strict observance of the *Shari'ah* compliance process is a critical factor that promotes investor confidence in the ICM. The approach adopted by different

countries in establishing *Shari'ah* governance framework can vary between jurisdictions as each jurisdiction needs to take into consideration its own unique requirements and circumstances.

Generally, the *Shari'ah* governance framework operates at three levels; namely, at the company, national, and international levels. At the company level, there are governance requirements for the appointment of *Shari'ah* advisers to advise on the *Shari'ah* aspects of the products and services offered by the company. The roles of the *Shari'ah* advisers are often supported by the appointment of compliance officers with knowledge of *Shari'ah* and Islamic finance. At the national level, *Shari'ah* advisory boards or councils can be established to advise the regulator and to provide top-down rulings and guidance on any *Shari'ah* issues pertaining to ICM business and transactions. Internationally, there are global standard setting organisations such as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)[9] and the Islamic Financial Services Board (IFSB).[10] The international standards issued by AAOIFI include *Shari'ah* standards that have been reviewed and approved by its *Shari'ah* board (comprising *fiqh* scholars). All the standards and pronouncements issued by AAOIFI are adopted by Kingdom of Bahrain, Dubai International Financial Centre, Jordan, Lebanon, Qatar, Sudan, and Syria. As for IFSB, one of its many objectives is to promote the development of a prudent and transparent Islamic financial services industry through introducing new, or adapting existing, international standards consistent with *Shari'ah* principles, and recommending these for adoption. In this regard, IFSB has issued various standards, guiding principles, and technical notes for the Islamic financial services industry, each of which has been endorsed as compliant with the rules and principles of *Shari'ah* by the *Shari'ah* scholars (in this instance, the Shariah Advisory Committee of Islamic Development Bank). With respect to the ICM, these standards include, amongst others, Guiding Principles on Governance for Islamic Collective Investment Schemes (January 2009) and Guiding Principles on Conduct of Business for Institutions offering Islamic Financial Services (December 2009).

Malaysia has sought to ensure that its *Shari'ah* governance framework is comprehensive and effective. At the company level, only qualified and experienced individuals and corporations are allowed to act as *Shari'ah* advisers. This is reflected in the requirements set out in the Registration of Shariah Advisers Guidelines and other product regulation guidelines[11] which establish fit and proper criteria for the appointment of *Shari'ah* advisers and as well as outlining their roles and responsibilities. To further raise professional standards, registered *Shari'ah* advisers are encouraged to keep abreast of developments in Islamic finance through requirements for continuous professional education. Various guidelines also specify the need for the appointment of compliance officers with basic knowledge of *Shari'ah* and Islamic finance.

At the national level, the Securities Commission Malaysia had in 2009 introduced amendments to its CMSA that included a specific provision for the establishment of national Shariah Advisory Council (SAC). Section 316A of the CMSA states that:

> *The Commission may establish a Shariah Advisory Council for Islamic capital market which shall be the authority for the ascertainment of the application of Shari'ah principles for the purposes of Islamic capital market business or transaction.*

The functions of the SAC as set out under Section 316B of the CMSA are to:

a. Ascertain the application of *Shari'ah* principles on any matter pertaining to ICM business or transaction and issue a ruling upon reference made to it.
b. Advise the Securities Commission Malaysia on any *Shari'ah* issues relating to ICM business or transaction.
c. Provide advice to any person on any *Shari'ah* issues relating to ICM business or transaction.

One significant provision of the CMSA allows reference to the SAC for advice or ruling from industry participants or any person, the courts, or arbitrators, and the binding effect of such rulings on the person or entity concerned. Section 316E of the CMSA states that any licensed person, stock exchange, futures exchange, clearing house, central depository, listed corporation, or any other person may seek the advice or refer for a ruling of the SAC on any matter relating to its ICM business or transaction to ascertain whether such ICM business or transaction involves any element that is inconsistent with the *Shari'ah*. In addition, section 316F(1) of the CMSA states that where in any proceedings before any court or arbitrator concerning a *Shari'ah* matter in relation to ICM business or transaction, the court or the arbitrator, as the case may be, shall take into consideration any ruling of the SAC or refer such matter to the SAC for its ruling.

Any ruling made by the SAC under sections 316E or 316F shall be binding[12] on the persons referred to in section 316E and the court or arbitrator referred to in section 316F, respectively. Further, section 316H states that where a ruling given by a registered *Shari'ah* adviser to a person engaging in any ICM business or transaction is different from the ruling given by the SAC, the ruling of the SAC shall prevail.

The SAC also plays its role in harmonising the decisions taken by the registered *Shari'ah* advisers. Whenever *Shari'ah* advisers are not able to give

answers or clarifications on certain *Shari'ah* issues, they will refer to the SAC for final rulings. In the event that any inconsistency arises between the *Shari'ah* advisers' views and the SAC's rulings, the latter shall prevail.[13] A similar framework is also adopted by Bank Negara Malaysia in regulating the Islamic banking and *takaful* business and transactions in Malaysia.[14] This model of *Shari'ah* governance is also adopted in other countries like Pakistan, whereby the *Shari'ah* supervision mechanism consists of *Shari'ah* advisers for banks undertaking Islamic banking, a *Shari'ah*-compliance inspection, and a centralised *Shari'ah* board for the country.

The rulings made by the SAC of the Securities Commission Malaysia are published in the *Resolution of the Securities Commission Shariah Advisory Council* (2009). This book acts as the reference to guide and to deepen understanding of the *Shari'ah* products and concepts applied in Malaysia's ICM. The SAC rulings are continuously incorporated into the relevant guidelines. For instance, the Securities Commission Malaysia revised the Islamic Securities Guidelines (Sukuk Guidelines) to provide greater clarity on the application of *Shari'ah* rulings and principles in relation to *sukuk* transactions as endorsed by the SAC.

As discussed earlier, Malaysia has made it mandatory for the court or arbitrators to refer any *Shari'ah* issues to the SAC and for the rulings made by the SAC to be binding on the courts or arbitrators. Tun Abdul Hamid Mohamed, the former chief justice of Malaysia, suggests that this approach is justified, as it ensures more thorough screening of *Shari'ah* products by well-known and highly reputable scholars. In addition, he points out that the establishment of a national SAC enables rulings on issues to be made more quickly as well as promoting greater consistency of rulings on *Shari'ah* issues. He further states that in Malaysia, the civil courts judges are in a position to look for the law but do not have the expertise to decide *Shari'ah* issues due to a lack of knowledge in *Shari'ah* and Islamic jurisprudence.

The case of *Mohd Alias bin Ibrahim v RHB Bank Berhad and Another* represents the first case on the legal effect of the SAC's rulings in Malaysia. While this applies to a banking dispute, nonetheless the same issues apply to ICM. The case is about the constitutional validity of Sections 56(1)[15] and 57[16] of the Central Bank of Malaysia Act, 2009 (Act 701) (CBA) and in relation to this, the plaintiff raised three questions for the court's determination:

1. Whether Sections 56 and 57 of the CBA are inconsistent with Article 121(1) of the Federal Constitution (i.e., by making the ruling of the SAC binding upon the court), and whether the SAC is usurping the jurisdiction of the court?
2. Whether by making the ruling of the SAC binding upon the court, such parties to such litigation are being deprived of their right to be heard?

3. Whether Sections 56 and 57 of the CBA have a retrospective effect on the transactions which occurred prior to the date the legislation came into effect, namely on November 25, 2009?

The High Court subsequently decided as follows:

1. Sections 56 and 57 of the CBA do not impugn the powers of the court. The decision-making power remains with the court and is not abdicated to the SAC. The SAC is merely required to make an ascertainment, and not determination, of Islamic laws related to the question. It will then be up to the court to apply the ascertained law to the facts of the case.
2. The second issue is premature, as the SAC has not published their procedure and the plaintiff cannot prove that they have a right to be heard or have been denied their right to be heard. The court also highlighted that in every case, it is not necessary to make a provision for a hearing;
3. Sections 56 and 57 have no retrospective effect, since there is no limitation imposed on the SAC in the performance of its statutory duties in the CBA.

5. CONCLUSION

Capital markets play an effective role in connecting the vast pool of savings and investment opportunities and contribute towards higher economic growth. Therefore, greater efforts must be made to harness the capabilities of markets so that the benefits of productive wealth may be better utilised to advance Muslim society.

As the domestic financial landscape evolves with the emergence of ICM, there is a need to ensure that this is accompanied by the development of a sound and comprehensive regulatory architecture that takes into account the unique legal and socioeconomic circumstances of that jurisdiction, fully meets the needs of issuers, investors, and intermediaries and ensures sustained confidence in the country's ICM.

NOTES

1. The International Organization of Securities Commission (IOSCO), which was established in 1983, is the international standard setter for securities market and is the primary international cooperative forum for securities market regulatory agencies.
2. *Bai' bithaman ajil* (BBA) is defined as a contract that refers to the sale and purchase of assets on a deferred and installment basis with preagreed payment

period. The tradability of BBA, and other debt instruments, tends to differ among jurisdictions.

3. *Musharakah* (profit and loss sharing) is defined as a partnership arrangement between two or more parties to finance a business venture whereby all parties contribute capital either in the form of cash or in kind for the purpose of financing the said venture. Any profit derived from the venture will be distributed based on a pre-agreed profit-sharing ratio, but a loss will be shared on the basis of capital contribution.
4. *Mudharabah* (profit sharing) is defined as a contract made between two parties to enter into a business venture. The parties consist of the *rabb al-mal* (capital provider) who shall contribute capital to finance the venture, and the *mudarib* (entrepreneur) who will manage the venture. If the venture is profitable, the profit will be distributed based on a pre-agreed ratio. In the event of a business loss, the loss shall be borne solely by the provider of the capital.
5. "Islamic Securities" is defined in Securities Commission (Prescription of Islamic Securities) Order 2004 as "(a) any product or instrument made available, offered for subscription or purchase, or issued pursuant to the Shariah principles of Mudharabah or Musharakah; or (b) any sukuk issued pursuant to any Shariah concept or principle; and which are specified as Islamic Securities under the Guidelines on the Offering of Islamic Securities issued by the Commission."
6. The Guidelines on the Offering of Islamic Securities were superseded and replaced with Islamic Securities Guidelines (Sukuk Guidelines) dated 12 July 2011.
7. Section 232(1)—A person shall not issue, offer for subscription or purchase, make an invitation to subscribe for or purchase or in the case of an initial listing of securities, make an application for the quotation of the securities on a stock market of a stock exchange unless—(a) a prospectus in relation to the securities has been registered by the Commission under section 233; and (b) the prospectus complies with the requirements or provisions of this Act.
8. Section 258—(1) Every person issuing, offering for subscription or purchase, or making an invitation to subscribe for or purchase, any debenture shall—(a) enter into a trust deed that meets the requirements of section 259; (b) appoint a trustee who is a person eligible to be appointed or to act as trustee in accordance with section 260; and (c) comply with the requirements and provisions of this Division.
9. AAOIFI, which was formed in 1990, is an Islamic international autonomous not-for-profit corporate body that prepares accounting, auditing, governance, ethics, and *Shari'ah* standards for Islamic financial institutions and the industry.
10. IFSB was inaugurated in 2002, to serve as an international standard-setting body of regulatory and supervisory agencies that have vested interest in ensuring the soundness and stability of the Islamic financial services industry, which is defined broadly to include banking, capital market, and insurance.
11. Guidelines on Unit Trust Funds dated 3 March 2008; Guidelines on Islamic Fund Management dated 3 December 2007; Guidelines on Real Estate

Investment Trusts dated 21 August 2008; Guidelines on Exchange-Traded Funds dated 11 June 2009.

12. Section 316G of the Capital Markets and Services Act 2007.
13. Section 316H of the Capital Markets and Services Act 2007.
14. Bank Negara Malaysia introduced *Guidelines on Shariah Governance Framework for Islamic Financial Institutions* in 2010 with the objective of enhancing the role of the board, *Shari'ah* committee, and the management in relation to *Shari'ah* matters. These guidelines provides guidance to the *Shari'ah* committee and Islamic financial institutions to discharge their duties in *Shari'ah* matters and the functions relating to *Shari'ah* review, *Shari'ah* audit, *Shari'ah* risk management, and *Shari'ah* research are also outlined in the guidelines. Further, Part VII Chapter 1 of the Central Bank of Malaysia Act 2009 provides the provisions for the establishment of Shariah Advisory Council at the national level, similar to the provisions as provided under the Capital Markets and Services Act 2007 for Islamic capital market business and transactions.
15. Where in any proceedings relating to Islamic financial business before any court or arbitrator any question arises concerning a Shariah matter, the court or the arbitrator, as the case may be, shall—(a) take into consideration any published rulings of the Shariah Advisory Council; or (b) refer such question to the Shariah Advisory Council for its ruling.
16. Any ruling made by the Shariah Advisory Council pursuant to a reference made under this Part shall be binding on the Islamic financial institutions under Section 55 and the court or arbitrator making a reference under Section 56.

REFERENCES*

Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), www.aaoifi.com.

Akhtar, Shamshad, Governor of the State Bank of Pakistan, "Shariah Compliant Corporate Governance," keynote address at the Annual Corporate Governance Conference, Dubai, (27 November 2006), www.bis.org/review/r070118b.pdf.

International Organization of Securities Commissions (IOSCO). 2008. Analysis of the Application of IOSCO's Objectives and Principles of Securities Regulation for Islamic Securities Products (September). www.iosco.org/library/pubdocs/pdf/IOSCOPD280.pdf.

Islamic Capital Market Task Force of the International Organization of Securities Commissions (ICM-IOSCO). 2004. Islamic Capital Market Fact Finding

*Details and complete texts of the acts and guidelines referred to in this chapter can be found at the websites of the Securities Commission Malaysia (www.sc.com.my) under the "Legislation" column, the Central Bank of Malaysia (www.bnm.gov.my) under the "Law, Policy and Guidelines" column, and the Islamic Financial Services Board (www.ifsb.org).

Report. ICM (July). www.sc.com.my/eng/html/icm/ICM-IOSCOFact%20finding%20Report.pdf.

Islamic Financial Services Board, www.ifsb.org.

Mohamad, A.H. 2011. "Malaysia as an Islamic Finance Hub: Malaysian Law as the Law of Reference and Malaysian Courts as the Forum for Settlement of Disputes." 12th Emeritus Prof. Ahmad Ibrahim Memorial Lecture, December.

Mohd Alias bin Ibrahim and RHB Bank Berhad (6171-M); RHB Islamic Bank Berhad (Company No. 680329-V), in the High Court of Malaya at Kuala Lumpur (Commercial Division), Suit No: D-22A-74–2010.

Securities Commission Malaysia. 2009. *Resolutions of the Securities Commission Shariah Advisory Council*, Revised Second Edition. www.sc.com.my/eng/html/icm/Resolutions_SAC_2ndedition.pdf

PART

Four

Corporate Governance and Human Resources

CHAPTER 20

Corporate Governance and Supervision: From Basel II to Basel III

Carol Padgett

1. INTRODUCTION: CORPORATE GOVERNANCE AND THE SPECIAL CASE OF BANKS

One of the best known definitions of corporate governance is the one used by the influential Cadbury Committee,[1] which described corporate governance as "the system by which companies are directed and controlled."[2] Over time the definition has been refined in various ways by authors who are keen to draw attention to the relationships involved in the process of direction, and crucially to specify for whose benefit the organisation is being controlled. Any definition rooted in economics focuses on the relationship between managers (in practice the board of directors, as controllers) and shareholders (as owners of the business in whose interests it is run). Given that most businesses are not entirely funded by equity, other approaches include lenders alongside shareholders as beneficiaries of the process. A still broader definition, and one which is espoused by the OECD,[3] is based on the idea that companies exist for the benefit of a range of stakeholders, so corporate governance is concerned with a set of potentially complex relationships between management, shareholders, lenders, employees, customers, and wider society.

This approach is useful in thinking about the corporate governance of banks because they play a pivotal role in the economy. We need look no further than the recent banking crisis for proof of this. Governments across the globe have rescued banks from failure, not because they wanted to protect the interests of their shareholders but because they wanted to protect depositors and to ensure that funds would be available to borrowers.

Islamic Finance: The New Regulatory Challenge.
Edited by Simon Archer and Rifaat Ahmed Abdel Karim
Copyright © 2013 by John Wiley & Sons Singapore Pte. Ltd.
ISBN: 978-1-118-62897-3

In other words, governments have bailed out banks in order to safeguard stakeholders. This view that banks are special because of their relationships with a myriad of stakeholders helps to explain why some countries regulating the governance of listed companies (including banks) through corporate governance codes have issued special codes for banks and other types of financial institutions. It also explains why international bodies like the Financial Stability Board (FSB) and the Basel Committee on Banking Supervision (BCBS) take such an active interest in banks' governance.

In this chapter we will consider some of the common features of corporate governance regulation affecting companies across the globe before going on to look at banks as a special case. The BCBS has published guidance on corporate governance in banks; here we will focus on recent changes in that guidance as it affects risk management, remuneration practices, and transparency in banking structures. As we will see, the recent banking crisis exposed shortcomings in each of these areas, so it is vital that banks improve their governance practices in order to protect themselves and to better serve their stakeholders.

2. REGULATION AND THE CORPORATE GOVERNANCE OF LISTED COMPANIES

If we accept the view that corporate governance is concerned with the relationships between stakeholders, it is clear that it is regulated in a variety of ways, including the laws on securities, bankruptcy, and employment as well as through accounting standards and stock exchange listing requirements. In many jurisdictions, a code of corporate governance[4] forms part of those listing requirements. Codes of corporate governance tend to focus on the role and composition of the board of directors, since it is ultimately up to the board to manage relationships between the company's various stakeholding groups. Most codes are based on the "comply or explain" principle, which means that the company can choose either to comply with the code's recommendations or to deviate from some or all of them, as long as it explains in its annual report or some other publication why it has chosen an alternative practice. Among the benefits of this approach are that it recognises the impossibility of formulating one set of rules that makes sense for all businesses in all situations, and that it requires companies themselves to draw attention to those practices that deviate from the code. This allows the market, rather than the regulator, to determine the importance of the deviation and, if it is judged serious, to "punish" the company by reducing its share price. While the detailed requirements differ from code

to code, most emphasise the importance of sharing power at the top of the organisation, of ensuring that directors can bring independent judgement to the board's deliberations, and of delegating specific areas of oversight to small subcommittees of the board.

While every board of directors has a variety of tasks to perform, most can be classified under one of two headings: strategy and monitoring. The implementation of strategy must be overseen by someone who works full-time in the company, while oversight of the monitoring function is arguably best done by someone who can bring truly independent judgement to bear on the company's behaviour. This is why most codes recommend that the chief executive officer (CEO) who runs the company should not chair, that is run, the board, arguing instead that the chair should be a non-executive or independent director. A non-executive director is simply a director who is not employed by the company in question, while to be deemed independent they must pass certain other tests, which vary from country to country but are designed to ensure that the director does not have business or personal links to this company. In countries where the stock market is large, there is a big pool of experienced directors from which to draw when choosing non-executive directors. This makes it viable to write the code in terms of independent directors. In countries where few companies are listed the number of available independent directors is much smaller, so it may be necessary to make recommendations with reference to non-executives, recognising that some of them may have business relationships with the companies on whose boards they sit.

In addition to the requirement that the board chair should be a non-executive or independent director, most codes specify that a minimum percentage of all board members should be either non-executives or independent. This allows the board to form smaller specialist independent subcommittees responsible for the oversight of specific areas of governance. The three subcommittees that are usually recommended are the audit, remuneration, and nomination committees. The audit committee has a wide remit. It is responsible for the oversight of the company's financial controls, reporting system, and relationship with its auditors. In the absence of a specialist risk committee it should also ensure that the risks taken by the business are compatible with the shareholders' preferences. The remuneration committee is responsible for formulating a remuneration policy that rewards executive directors for creating shareholder wealth. This involves the design of remuneration packages that build in the right blend of incentives. In doing this, the committee may draw on the expertise of remuneration consultants. It is up to the nomination committee to recognise skills gaps on the board and to seek out new independent directors who can fill those gaps as and when board vacancies occur.

Implicit in the discussion so far is the assumption that companies are overseen by a single board. While this is the case in English-speaking countries, the dual-board system is used extensively in continental Europe and Asia. While the details vary from country to country, in this system a team of executives forms the management board, which as the title suggests is responsible for the strategy and management of the company, overseen by a supervisory board made up of independent directors and in some cases, employees or their representatives. In such a system there is a clear distinction between the CEO who runs the company and sits on the management board and the chair of the supervisory board, and the subcommittees are drawn from the members of the supervisory board to ensure that they operate independently.

Codes of corporate governance apply to all banks that are listed on the stock market. Clearly, bearing in mind recent controversies over the operation of banks, the functions of the audit or risk committee and the remuneration committee are of specific interest in the banking industry. These are influenced by Basel II and in some states by additional codes of conduct applying only to banks. In some countries (Georgia,[5] Nigeria,[6] Qatar,[7] and Singapore,[8] for example) the board is urged to set up a risk committee; in The Netherlands it is up to the executive board to specify the bank's risk appetite for approval by the supervisory board at least once a year. In addition, the Dutch code specifies that executive board members' remuneration must be consistent with the bank's risk policy. This emphasis on risk in banking codes is entirely consistent with the advice of the BCBS, as we will see in the next section of this chapter.

3. BASEL PILLAR 2 AND CORPORATE GOVERNANCE IN BANKS

Basel II is based on the BCBS's Three Pillars of Regulation. The first is concerned with minimum capital requirements, where capital is defined in relation to market risk. The second relates to the supervision of capital adequacy, and the third to market discipline based on reporting by banks. Pillar 2 is based on four key principles, the first of which is of most interest in the context of corporate governance because it relates to banks rather than to their supervisors, as the other three do. This principle states that "banks should have a process for assessing their overall capital adequacy in relation to their risk profile and a strategy for maintaining their capital levels."[9] Given that this principle refers to risk and strategy, it links directly to the operation of banks' boards whose governance role extends to risk and capital adequacy. The BCBS has been offering guidance on the enhancement of corporate governance since 1999. That guidance is based on the OECD

"Principles of Corporate Governance," which were first published in 1999 then amended in 2004. The BCBS has followed the OECD's lead, updating its advice as the OECD principles were updated, but has in addition offered further guidance in the light of the financial crisis of 2007 and beyond.

The OECD principles cover six areas of governance more general than the provisions discussed in Section 2. This reflects the fact that the principles are designed to guide policy makers around the world. Some will be using them to start from scratch in regulating governance, while others will be building on existing legislation. The six principles discuss the basis of an effective governance framework, shareholder rights, the treatment of stakeholders, transparency, and the role of the board. As we have already seen, national corporate governance codes tend to focus on the role of the board, as do the eight principles discussed in BCBS (2006).[10] These eight principles had grown to fourteen by the time the BCBS published its 2010 principles.[11] They provide rather more detail in three key areas of governance that have assumed greater prominence since the 2007 banking crisis and its aftermath. These are risk management, remuneration practices, and transparency in corporate structures.

3.1 Risk Management

The OECD principles state clearly that risk management is a key responsibility of the board of directors. While legislation usually implies that the entire board has responsibility for the oversight of fundamentally important areas like this, in practice much of the work is devolved to either the audit committee or to a specialist risk committee. The BCBS is concerned that risks are poorly articulated and communicated between different divisions of banks, implying that risks taken at lower levels in the organisation can thwart board policy, yet recent evidence suggests that boards themselves, acting in the interests of shareholders may be responsible for excessive risk taking in banks.

The moral hazard problem facing shareholders is well documented in the corporate finance literature. The risk faced by shareholders increases when companies use debt financing because the risk associated with the assets financed by debt is borne by the shareholders, and in addition interest payments increase costs and so reduce the profit pool from which dividends are paid. This can lead shareholders to advocate risk taking, knowing that when the risks pay off they will reap all the benefits, but when things go wrong the debt holders will share the pain as the company struggles to make interest payments and, in the last resort, becomes insolvent, so that the debt holders are left facing losses.[12] This may be a particular problem in banks, given that, as Gualandri and colleagues[13] point out, they are often more

highly leveraged than other firms. This propensity to take risk is heightened if the company is protected from the worst consequences of such financial distress. Again this is exactly the case in the banking industry where deposit insurance and the too-big-to-fail mentality protect banks from the consequences of poor or overly risky decision making.

Laeven and Levine[14] provide evidence based on data from 48 countries that concentrated ownership leads to greater risk taking. While risk taking can be mitigated by strong regulatory oversight of banks, this effect is felt less strongly when ownership is concentrated in the hands of a few large shareholders. Caprio and colleagues[15] provide evidence that block holders are important owners of bank shares. In their sample of banks in 44 countries, the "average" country has 75 percent of its banks controlled by a block holder. This means that regulators need to find ways to curb the tendency of shareholders to encourage risk-taking. One possible solution is implied by Pathan.[16] He finds that strong boards, those that represent shareholders' interests, are associated with greater risk taking by American banks. His definition of a strong board is three-fold, based on small board size, the proportion of independent directors, and finally nonrestrictive shareholder rights, which are measured by the absence of both a staggered board[17] and of poison pills. While small boards and nonrestrictive shareholder rights lead to more risk taking, when the board has a higher proportion of independent directors the bank takes fewer risks. This may be because these directors take a wider, stakeholder-oriented view of their role, rather than acting solely on behalf of their shareholders.

The tension between independent directors and powerful shareholders appears also in the work of Erkens and colleagues.[18] They examined the consequences for institutional shareholders and independent boards for banks' stock returns in 30 countries during the financial crisis. They found that higher levels of institutional ownership and board independence were associated with lower returns. They hypothesised that this was related to risk taking before the onset of the crisis, but crucially discovered that while greater institutional ownership encouraged risk taking, board independence did not. In fact those banks with independent boards raised equity to boost their capital, which transferred wealth to their debt holders from the existing shareholders, consistent with a stakeholder orientation. These findings are important because empirical evidence on the relationship between board independence and corporate value in nonfinancial institutions is largely inconclusive, casting doubt on the efficacy of independent directors. Here we can see a clear rationale for regulation that encourages board independence in banks so as to alleviate the moral hazard problem.

To make sure that policy and day-to-day decisions are consistent with its strategy the board is advised[10] to establish a risk committee, and if

the bank is large or has international operations, to appoint a chief risk officer (CRO). The risk committee should be responsible for advising on the bank's risk appetite both today and in the future. Both the risk management function within the bank and the CRO should have access to the committee, which should also be able to take advice from external experts on matters such as mergers and acquisitions. The principles give no guidance on the composition of the committee, but national codes of corporate governance—those that assume risk management will be undertaken by the audit committee—usually specify that it should be independent. Given the evidence discussed earlier, this would be sound advice in the case of banks where risk should be considered from a stakeholder perspective.

The CRO plays a key role in directing the risk management function and communicating with the risk committee. The principles describe the CRO as an "independent senior executive." The CRO should be independent in the sense that he or she should not take responsibility for specific lines of business and should not also serve as the CFO, chief auditor, or other officer of the bank. This allows the post holder to step back from operational issues and to consider risk at the level of the bank. The risk management function should model current risks and use stress tests to understand future risks, communicating the results both across the organisation and up to the risk committee. This should increase the awareness of risk among key personnel so that they recognise how their decisions contribute to the risk profile of the bank as a whole. The principles again make specific mention of mergers and acquisitions, stressing the importance of due diligence, which was inadequate in the Royal Bank of Scotland's acquisition of ABN Amro and contributed to its failure.[19]

Given the importance of controlling shareholders in the banking industry and the belief that governments will not allow financial institutions to fail, it is not surprising that banks take bigger risks than their stakeholders would approve. The BCBS[10] emphasis on risk management through a board-level risk committee and the CRO is a logical response. This response can succeed only if bankers have incentives to reduce risk. Given that high risk goes hand-in-hand with high expected return, and bankers are rewarded for creating returns, there is a danger that risk reduction strategies based on board structures alone will not be effective. For this reason, we turn now to an examination of remuneration in the banking industry.

3.2 Remuneration Practices

Remuneration is probably the most controversial, or at least the most talked-about, area of corporate governance. This applies to the banking sector more than any other, given that following the banking bailouts we, the general

public, now see ourselves as owners, not just because we invest in pension funds that hold bank equity, but because we are taxpayers who did not participate in our governments' decisions to hold shares in major banks. The other distinguishing feature of banking remuneration is that the public is aware of the bonuses paid to bankers who are not board members, while in other sectors it is the pay of company directors that grabs the newspaper headlines.

According to the FSB in 2009,[20] flawed compensation practises contributed to the 2007 crisis. It therefore published a set of principles relating to remuneration. In 2010 the BCBS[21] reacted by offering guidance to bank supervisors on the implementation of these principles. The principles aim to ensure that the remuneration paid to bank directors (and to other staff who are in a position to change the risk faced by the bank) should reflect that risk as well as the bank's returns. The suggestion is that this can be achieved by developing a closer relationship between the remuneration and risk committees, changing the balance between bottom-up and top-down payment systems and ensuring that deferrals and clawbacks give the right incentives to those employees who affect risk.

We saw earlier that corporate governance regulation usually requires boards to set up independent remuneration committees to determine the size and composition of executive directors' remuneration packages. The overarching aim of the system is to design packages that attract, retain, and motivate directors. Attraction and retention depend on offering a salary and other benefits that are comparable with those offered in competing companies. This explains the widespread use of remuneration consultants with knowledge of industry norms. They are able to tell individual companies how their salary levels stand in relation to the industry median, often labelling any payment below the median as uncompetitive and hence unlikely to attract or retain. To avoid being uncompetitive, the company raises its payment levels, contributing to a ratchet effect as others in the industry follow suit. Motivation is achieved by offering short- and long-term bonuses based on profitability or shareholder returns, usually measured in relation to a stock market index or to a group of peer companies.

These variable components of the package are often paid in the form of shares or options, which can be sold or exercised sometime in the future. The use of options is controversial, because they are often designed with a low exercise price—which means that they become profitable when the share price moves up only slightly—so they do not motivate directors to work much harder or smarter than they do now. In addition the value of options depends not just on the absolute value of the underlying share, but also on its volatility. Given that the relationship is positive, the value of options increases with volatility, encouraging directors to take risks. In the past it

was argued that managers are inherently more risk-averse than shareholders because they have human capital tied up in their organisations. Options were therefore seen as a means to encourage greater risk taking in line with shareholders' preferences.[22] Such an argument would be highly unpopular today as many people blame excessive risk taking on the use of options in remuneration packages. Interestingly, recent papers suggest that this conclusion is erroneous. Using very different data sets Ayadi and colleagues[23] (for Europe) and Fahlenbrach and Stulz[24] (for the United States) conclude that option-based remuneration does not encourage greater risk taking in banks. Rather, the use of long-term incentive plans based on performance over a period of time were associated with bank failure in the case of European banks, while American bankers, like their shareholders, experienced a wealth loss during the crisis.

Even if options are not to blame, bankers have taken risks that have backfired on shareholders, so it is not surprising that the FSB aims to ensure that bankers are not rewarded for taking undue risks. It therefore recommends that the remuneration committee should work with the risk committee to make sure that the variable compensation offered takes account of the current and future risks faced by the bank, and does not limit its ability to build its capital base. This is not to deny the importance of variable or performance-related remuneration. In fact the FSB recommends that a substantial part of the total package received by employees who affect the bank's risk profile should be variable. However, it is also keen that a large proportion of the variable component should be deferred and should be awarded in equity or a related instrument, so as to ensure that recipients are motivated to continue performing strongly in order to reap rewards in the future. Employees working in the compliance and risk-management functions of the bank are the exception to this general principle. To ensure that they operate independently, the FSB recommends that their packages should be determined separately from those in other business areas and that performance should be measured in terms of achieving broad objectives rather than narrowly specified return or risk targets.

In providing guidance on the FSB principles, the BCBS suggests a need to reconsider the balance between the use of top-down and bottom-up systems, both of which are used to determine remuneration in banks. Anyone who reads the newspapers is familiar with the idea that banks declare bonus pools and then share them out between their star performers. This reflects a top-down or award-focussed system. The bank's performance determines the size of the bonus pool, which is then shared out, often on the basis of short-term performance by individuals. This method ignores the risk assumed by those individuals and any "legacy losses" brought forward and recognised during the period. The alternative is a bottom-up or payment-focussed

system based on the individual's performance rather than the bank's. This allows the risk assumed by individuals to be taken into account and is therefore more likely to change behaviour.

There is no doubt that shareholders are hungry for change in the way that bankers are paid. During the spring of 2012 significant numbers of shareholders voted against the remuneration packages offered at Barclays, Credit Suisse,[25] and UBS.[26] One of the issues that sparked controversy at Barclays was the fact that the bonus pool was larger than the dividend payout. Shareholders voted nearly 27 percent of the shares against the remuneration report. While clearly nowhere near a majority, this is a significant "no" vote. The Walker Review[27] into corporate governance in the United Kingdom banking industry states that when fewer than 75 percent of votes are cast in favour of the remuneration report, the chair of the remuneration committee should stand for re-election the following year. In the Barclays case, the chair of the committee was due for reelection in 2012. Nearly 21 percent of votes were cast against her, a far higher proportion than those cast against any other director, indicating the strength of feeling of the shareholders.[28]

Clawbacks of banking remuneration at HSBC,[29] Lloyds,[30] and UBS[31] in February 2012 also sparked media interest. As mentioned earlier, clawbacks are recommended by the BCBS as a way of ensuring that risk features in the design of remuneration packages; they force employees to return some or all of a bonus payment received in the past when additional risks or other unwanted behaviour come to light. In the United States, the Sarbanes-Oxley Act of 2002 permits the clawback of bonuses paid as a result of employee misconduct, such as the deliberate misstatement of earnings. In practice the act is rarely used to recover such payments, partly because only the SEC can bring legal actions under this legislation, and it simply does not have adequate resources to bring every case to trial. The Dodd–Frank Act of 2010 goes some way towards remedying this situation. It requires companies that have to restate their financial results, whether as a result of misconduct or mistake, to clawback "underserved" payments already made to employees. Rather than allowing the clawback of an entire bonus, this legislation requires the repayment of that portion of the bonus that is not justified under the restated figures. Like the Sarbanes-Oxley Act and much of the governance regulation already discussed, this applies to all listed companies, not just to banks. In the United Kingdom, the Walker Review, which applies only to banks and other financial institutions, allows clawbacks in the event of misstatement and misconduct.

The actions of banks in taking back bonuses and of shareholders in voting against remuneration reports are indicative of a new determination to reform compensation practices in banks. The timing suggests that the market

has taken heed of the regulators and realised that change is necessary to provide the right incentives to bankers.

3.3 Transparency and Banking Structures

The third area in which there has been considerable change between the publication of the 2006 and 2010 "Principles for Enhancing Corporate Governance" is in the area of complex banking structures. Having previously suggested that poorly constructed remuneration packages encouraged risk taking by bankers, we come now to see how those risks were manifested in the form of structured products and special-purpose entities (SPEs). Structured products allow investors to gain exposure to asset classes that they cannot normally access. Real estate provides a simple example. Buildings are "lumpy," to use a word beloved of economists. They are large and expensive, making it difficult for most people to incorporate them in their portfolios. Securitisation took away the lumpiness of real estate by creating securities based on underlying buildings so that a whole range of investors could include a single piece of real estate in their portfolios. Securitisation has been practised since the 1980s and is not in itself a problem. The problems we have seen recently arose because of the rise of the so-called shadow banking system, in which banks created SPEs to raise funds and to create more complex structured products, whose risks were not always understood by the holders.

A special-purpose entity is an organisation created by, but legally separate from, the company that forms it. This means that while the bank creating an SPE is regulated by the relevant banking supervisor, the SPE it has formed is not regulated. SPEs are usually created to hold and finance specific assets, taking both the asset and the financing off the balance sheet of the originating company and thereby increasing the bank's regulatory capital. For example, the SPE could hold the cash flows from credit card receivables or mortgage payments on either residential[32] or commercial[33] property as assets financed by a bond issue, creating a form of collateralised debt obligation (CDO). If sufficient numbers of people are unable to pay their credit card bills or mortgages, bondholders lose out but the originating company is unaffected because the risk associated with the asset was transferred to the SPE. In a variant on this security, a synthetic CDO is based on credit default swaps (CDSs) rather than on debt contracts. A CDS is a security that makes a payment in the event of a credit event. This type of security is used by banks to insure against a borrower going bankrupt.

Even before the banking crisis, Partnoy and Skeel[34] warned that these products could have adverse consequences. They focussed on the relationship between banks and the companies to which they lend, explaining that if

the bank insures itself using CDOs, it is hedged against bankruptcy risk and so is less concerned to monitor the borrower and offer advice if it is heading for trouble. In this way the borrower loses a valuable corporate governance mechanism. Barth and Landsman[35] argue that the bank itself may be less well governed as investors do not have the incentive to monitor the quality of off-balance sheet loans. Further, as banks create more and more complex structured products, their relationships with other stakeholders become more complicated and the potential for moral hazard increases.

Some banks, faced with the prospect that investors in SPEs would lose money, decided to take the assets held by SPEs back on to their own balance sheets in order to safeguard their reputations.[36] Others that had guaranteed credit lines to the SPEs to bolster their credit ratings had no choice but to take their assets back on to their books. This forced them to show the assets at their (now reduced) market value and to recognise the losses associated with those assets under fair-value accounting. This both reduced profitability and created the need to raise regulatory capital by making issues in a depressed market. It also meant that in order to avoid taking on more risk the banks stopped lending to companies and to each other, transferring the crisis to the real economy and reducing liquidity in the banking sector.[37]

The widespread surprise and incredulity in financial markets as risky assets reappeared on banks' balance sheets and liquidity dried up indicate the lack of understanding of the size of the shadow banking sector and the complexity of the instruments traded there. This is why BCBS emphasises the danger of opaque corporate structures in its "know-your-structure" and "understand-your-structure" principles.

BCBS[9] is clear that it is the board's responsibility to understand the bank's structure and in particular the implications for risk of setting up complex structures such as SPEs. Senior management should apply to the board for permission to set up such structures with the understanding that where possible, they should be avoided. Where they are necessary the risks associated with the structures should be understood and each new entity should be subject to internal audit and regular assessment of how its risks impinge on the rest of the organisation. Where complex structures are established on behalf of customers for whom structured products are created, the bank must be aware that their customers' motivation could lead to inappropriate behaviour that could damage the bank's reputation. Again it is up to senior management and the board to monitor such situations, ensuring that the structures and products are used for their intended purpose, and that the risks of these activities are managed. In addition the bank must be ready to discuss these arrangements and the policy governing them with its supervisors. This is one aspect of transparency vital to corporate governance. The bank must also make relevant disclosures to other

stakeholders so that they can understand both the bank's structure and its risk appetite.

These exhortations have been supported by accounting standards setters who have changed their reporting requirements to improve the quality of information available to investors and other stakeholders in banks' annual reports.[38] U.S. GAAP and IFRS now have very similar requirements to consolidate SPEs in banks' financial statements and to provide narrative information on the relationship between the bank and the assets and liabilities of the SPE.

4. CONCLUSION

The traditional focus of the corporate governance literature is the relationship between corporate governance and performance. Researchers hypothesise that improved governance will lead to improvements in profitability and/or market value. We know that risk and expected return move together, but until the banking crisis we gave insufficient consideration to the relationship between governance and risk. As we have seen in this chapter, banks and wider society have learned some hard lessons on this subject since 2007. International authorities now recognise that banks must be governed and regulated from a broadly defined stakeholder perspective. They need strong independent directors who are willing to challenge the interests of shareholders in order to ensure that banks are able to operate for the benefit of their clients and other stakeholders.

In this chapter, we have focussed on three related areas for change in bank governance. The first is a greater emphasis on risk in both board-level discussions and throughout banking operations. This should be facilitated through the establishment of a board-level risk committee, the introduction of the CRO role, and the work of the risk function within the bank. The increased focus on risk will only be effective if employees do not have incentives to increase risk in order to raise return and hence improve their remuneration. For this reason banks have been encouraged and indeed have started to clawback bonuses paid as a result of inappropriate behaviour and to ensure that remuneration packages are constructed so as to be consistent with the bank's risk appetite. Finally, regulators have challenged boards to fully understand the potentially complex structures of their operations, particularly in respect to the relationships between banks and SPEs, and to see them as "special" in the sense that they should be used sparingly. In addition, accounting standards are changing to enhance the transparency of these arrangements so that stakeholders should in future have a better understanding of the risks taken by banks.

NOTES

1. Financial Reporting Council, "The Financial Aspects of Corporate Governance" (FRC 1992).
2. This wording reflects the fact that the Cadbury Committee's terms of reference related to the commercial sector, whereas corporate governance is an issue for nonprofit corporations, including such entities as universities. However, this chapter is concerned with the commercial sector.
3. Organisation for Economic Co-operation and Development, "Principles of Corporate Governance" (OECD 2004).
4. As an indication of the importance of codes in regulation, the website of the European Corporate Governance Institute (www.ecgi.org) provides links to the codes operating in more than 80 countries worldwide.
5. Association of Banks of Georgia, "Corporate Governance Code for Banks" (ABG 2009).
6. Central Bank of Nigeria, "Code of Corporate Governance for Banks In Nigeria Post Consolidation" (CBN 2006).
7. Qatar Central Bank, "Corporate Governance Guidelines for Banks and Financial Institutions" (QCB 2008).
8. The Monetary Authority of Singapore, "Guidelines on Corporate Governance for Banks, Financial Holding Companies and Direct Insurers which Are Incorporated in Singapore" (MSA 2010).
9. Basel Committee on Banking Supervision, "International Convergence of Capital Measurement and Capital Standards: A Revised Framework" (Bank for International Settlements [BIS] 2006).
10. Basel Committee on Banking Supervision, "Enhancing Corporate Governance for Banking Organisations" (Bank for International Settlements [BIS] 2006).
11. Basel Committee on Banking Supervision, "Principles for Enhancing Corporate Governance" (Bank for International Settlements [BIS] 2010).
12. This is known in the finance literature as the "shareholders' call option" according to which, if the company is worth less than the amount of debt, the call option is "out of the money" and the shareholders will leave the company to the debt holders. This is one consequence of the shareholders' limited liability.
13. E. Gualandri, A. Stanziale, and E. Mangore, "Internal Corporate Governance and the Financial Crisis: Lessons for Banks, Regulators and Supervisors." Paper presented at the IAAER Conference, Venice, 4–5 November, 2011.
14. L. Laeven and R. Levine, "Bank Governance, Regulation and Risk Taking." *Journal of Financial Economics* 93 (2009), 259–275.
15. G. Caprio, L. Laeven, and K. Levine, "Governance and Bank Valuation," *Journal of Financial Intermediation* 16 (2003), 584–617.
16. S. Pathan, "Strong Boards, CEO Power and Bank Risk-Taking." *Journal of Banking and Finance* 33 (2009), 1340–1350.
17. When a board is "staggered" or "classified," a proportionate number of the directors is eligible for reelection each year. A staggered board may act as an anti-takeover device in that it is hard to get agreement for a deal from a changing

board. Given that anti-takeover devices protect incumbent management, they are a sign that shareholders' rights are restricted.
18. D.H. Erkens, M. Hung, M., and P. Matos, "Corporate Governance in the 2007–2008 Financial Crisis: Evidence From Financial Institutions Worldwide," *Journal of Corporate Finance* 18 (2012), 389–411.
19. Financial Services Authority, "The Failure of the Royal Bank of Scotland" (FSA 2011).
20. Financial Stability Board, "FSB Principles for Sound Compensation Practices: Implementation Standards" (FSB 2009).
21. Basel Committee on Banking Supervision, "Compensation Principles and Standards Assessment Methodology" (Bank for International Settlements [BIS] 2010).
22. See for example, C.W. Smith and R.M. Stulz, "The Determinants of Firms' Hedging Policies" *Journal of Financial and Quantitative Analysis* 20 (1985), 391–405.
23. R. Ayadi, E. Arbak, and W.P. De Groen, "Executive Compensation and Risk Taking in European Banking, " in J.R. Barth, C. Lin, and C. Wihlborg, eds., *Research Handbook on International Banking and Governance* (London: Edward Elgar, 2012).
24. R. Fahlenbrach and R.M. Stulz, "Bank CEO Incentives and the Credit Crisis." *Journal of Financial Economics* 99 (2011), 1–26.
25. http://uk.reuters.com/article/2012/04/27/uk-barclays-creditsuisse-agm-idUKBRE83Q0B020120427, accessed June 22, 2012.
26. www.bloomberg.com/news/2012-05-03/ubs-improved-controls-after-trading-loss-chief-ermotti-says.html, accessed June 22, 2012.
27. H.M. Treasury, "A Review of Corporate Governance in UK Banks and Other Financial Industry Entities: Final Recommendations" (2009).
28. Poll results can be downloaded at www.group.barclays.com/about-barclays/investor-relations/annual-general-meetings.
29. This followed the misselling of long-term care bonds to older customers, see www.telegraph.co.uk/finance/newsbysector/banksandfinance/9107147/HSBC-set-to-claw-back-mis-selling-bonuses.html, accessed 19 June 2012.
30. This followed the misselling of payment protection insurance, see www.thisismoney.co.uk/money/news/article-2103654/Lloyds-claw-1m-plus-bonuses-wake-PPI-scandal.html accessed 19 June 2012.
31. This followed a rogue trading scandal; see www.telegraph.co.uk/finance/newsbysector/banksandfinance/7206896/UBS-claws-back-180m-of-bonuses.html, accessed 19 June 2012.
32. In the case of a residential mortgage-backed security or RMBS.
33. In the case of a commercial mortgage-backed security or CMBS.
34. F. Partnoy and D.A. Skeel, "The Promise and Perils of Credit Derivatives." *University of Cincinnati Law Review* 75 (2007), 1019–1052.
35. M.E. Barth and W.R. Landsman, "How Did Financial Reporting Contribute to the Financial Crisis?" *European Accounting Review* 19 (2010), 399–423.

36. P. Andre, A. Cazavan-Jeny, W. Dick, C. Richard, and P. Walton, "Fair Value Accounting and the Banking Crisis in 2008: Shooting the Messenger." *Accounting in Europe* 6 (2009), 3–24.
37. J. Crotty, "Structural Causes of the Global Financial Crisis: A Critical Assessment of the 'New Financial Architecture.'" *Cambridge Journal of Economics* 33 (2009), 563–580.
38. See Barth and Landsman (2010), note 35.

CHAPTER 21

Specific Corporate Governance Issues in Islamic Banks

Simon Archer and
Rifaat Ahmed Abdel Karim

1. INTRODUCTION

Prior to the recent financial crises there was already a growing interest in the corporate governance of banks (Caprio and Levine 2002; Charkham 2003; Levine 2003; Macey and O'Hara 2003). Not surprisingly, this interest has grown further following the crises (Dermine 2011; Kirkpatrick 2009; OECD 2009; Peni and Vähämma 2011).

Banks, like any other organisation, have a number of stakeholders, such as shareholders and debt holders, as well as boards of directors, competitors, and so on. This suggests that the need for a separate analysis of the corporate governance of banks is not self-evident and requires justification. However, the occurrence of the crises supports the view of those (e.g., Charkham 2003, 15) who argue: "Banks are different from the generality of companies in that their collapse affects a far wider circle of people and moreover may undermine the financial system itself, with dire effects for the whole economy." Further, Caprio and Levine (2002) and Levine (2003) identify three characteristics that they claim warrant an independent discussion of the governance of banks. They argue that banks are generally more opaque than other financial institutions, which fundamentally intensifies the agency problem. Second, banks are exposed to heavy regulation. Third, the widespread government ownership of banks raises specific governance issues.

The debate in the corporate governance literature has mainly concentrated on whether corporate governance should focus exclusively on protecting the interests of shareholders, or whether such a focus should be broadened to

Islamic Finance: The New Regulatory Challenge.
Edited by Simon Archer and Rifaat Ahmed Abdel Karim
Copyright © 2013 by John Wiley & Sons Singapore Pte. Ltd.
ISBN: 978-1-118-62897-3

protect the interests of other stakeholders (Macy and O'Hara 2003). A central issue in this debate is whether the directors of the organisation owe fiduciary duties of care and loyalty only to the shareholders of the organisation, or also to other stakeholders. What may be termed the "Anglo-American" or "neo-liberal" approach to corporate governance adopts the view that creation of value for shareholders should be given priority over the interests of other stakeholders. On the other hand, the "Continental European" approach (whether neostatist as in France, or neocorporatist as in Germany) to corporate governance calls for equal attention to be given to the interests of the other stakeholders in the organisation as well as to those of the shareholders.

Islamic banks are ethically funded organisations that primarily cater to the growing needs of Muslims who adhere to the *Shari'ah* rules and principles in investing their funds. These banks are currently the main type of financial institutions available for Muslims, because non-bank forms of intermediation in Islamic finance, unlike their conventional counterparts, are neither traditionally relied on nor well developed. A report by the International Organization for Securities Commissions (IOSCO) confirms the dominance of the Islamic banking sector within the Islamic financial services industry. It states, "As a result of its early head-start, Islamic banking is today the most developed component in the Islamic financial system and Islamic banks represent the bulk of Islamic financial institutions worldwide" (IOSCO 2004, 14–15). In contrast, Islamic insurance (*takaful*) is less developed although it is well established in some countries, notably Malaysia.

In place of interest-bearing deposits, Islamic banks mobilise funds through profit-sharing and loss-bearing investment accounts whose returns are, as a matter of *Shari'ah* jurisprudence (that is, that of the *mudarabah* contract, as explained below), based on the performance of the asset portfolios in which their funds are invested. Less commonly, a *wakalah* (agency) contract may be used in which the funds are managed by a *wakeel* (agent) in return for a fee which normally includes a fixed amount plus a performance-related element. The corporate governance issues raised are similar to the case of *mudarabah*, and in what follows references to such issues in the case of mudarabah should be understood as applying to *wakalah*. In the majority of Islamic banks, such investment accounts contribute the preponderant amount of the funds available to the bank for investment. However, investment account holders (IAHs) lack rights of governance such as shareholders enjoy, although like shareholders they are (legally speaking) a type of equity holder with residual claims to their share of the bank's assets (Archer, Karim, and Al-Deehani 1998). While debt holders, with fixed contractual claims to the firm's cash flows and assets, do not need a governance structure provided that these claims are met, residual claimants by definition have no such contractual rights and thus require a governance structure to protect their interests (Williamson 1996, Chapter 12); as Williamson points out, the law typically provides a governance structure for

debt holders *in case of default*. In the case of IAHs, neither the *Shari'ah* nor secular law makes any such provision.

The absence of any governance structure in the case of IAHs is thus an anomaly and raises fundamental corporate governance issues—for example, possible conflicts of interest between the two classes of equity holders, disclosure of adequate information to enable IAHs to protect their interests, and so on. It also draws attention to market discipline, which was emphasised for the first time by the Basel Committee on Banking Supervision (BCBS) in its capital adequacy framework (2004), known as Basel II, and raises the issue of the extent to which IAHs have the necessary mechanisms to exercise effective discipline on the management of the bank, given their lack of governance rights (see Archer and Karim 2006b). Furthermore, the mobilisation of funds through IAHs highlights the need to examine the approach adopted by central banks to regulate Islamic banks in order to help sustain the soundness and stability of the financial systems in the countries in which these banks operate (see Archer, Karim, and Sundararajan 2010, and Archer and Karim 2009, 2012).

This chapter attempts to enhance our understanding of the intricacies of corporate governance, market discipline, and regulation of Islamic banks. It argues that the existence of such profit-sharing and loss-bearing investment accounts with their equity-like, rather than liability-like, characteristics according to *Shari'ah* jurisprudence, together with a lack of clarity regarding the status of these investment accounts in practice, raise important questions of corporate governance, transparency, market discipline, and regulation for Islamic banks, which are examined below.

The remainder of the chapter is organised as follows. Section 2 discusses the salient characteristics of Islamic banks. Section 3 considers corporate governance issues of Islamic banks, and Section 4 examines the exercise of effective market discipline on the management of Islamic banks. The regulation of Islamic banks is addressed in the penultimate Section 5, and some concluding remarks are made in Section 6.

2. SALIENT CHARACTERISTICS OF ISLAMIC BANKS

Islamic banks (like any type of Islamic business organisation) are established so as to conduct their financial transactions in accordance with Islamic *Shari'ah*[1] rules and principles, which prohibit, among other things, the receipt and payment of *riba*[2] (interest). This means that Islamic banks cannot enter into interest-bearing borrowing or lending contracts, which is the basic business model of conventional banks.

As an alternative to the payment of interest, Islamic banks use two main types of accounts to mobilise funds, namely: (1) investment accounts, which

are in most cases based on a version of the profit-sharing and loss-bearing *mudarabah* contract[3] (or a *wakalah* contract) under which the funds are managed by the bank on behalf of their holders; and (2) current accounts. Investment accounts, unlike equity shares, are of limited duration and holders have the right to withdraw their funds subject to certain conditions (see below). Current accounts are sight deposits—that is, debt claims on the bank that can be withdrawn at any time—and are not entitled to any remuneration; they are "capital certain" since repayment is a contractual right protected by the bank having adequate equity capital. Islamic banks, therefore, perform a combination of two basic functions to mobilise funds, investment management and commercial banking, in addition to raising funds by issuing shares of common equity. As an alternative to lending funds and charging interest on them, Islamic banks use various *Shari'ah*-compliant financing contracts (for example, *murabahah*, *musharakah*, *ijarah*, *salam*, *istisna'a*, and so on)[4] to invest funds available, which include funds under management for IAHs as well as the bank's own (shareholders') funds and those from current accounts. (See Exhibit 21.1 for a stylised balance sheet of an Islamic bank.) Funds under management for IAHs include both unrestricted and restricted IAH funds. The funds of the unrestricted IAHs are invested at the bank's discretion, normally in the same asset pool as that in which the bank's own funds and those from current accounts are placed. In contrast, the funds of the restricted IAH are invested in asset pools that are separately designated and distinct from the bank's own funds (see Exhibit 21.1).

Islamic banks do not erect firewalls to separate, legally, financially, and managerially, their investment management and commercial banking services. Instead, as noted above and in contrast to the regulatory requirements in a number of European countries,[5] the majority of Islamic banks commingle unrestricted IAH funds with their own funds, invest both under the

EXHIBIT 21.1 Stylised Balance Sheet of an Islamic Bank

Assets	Liabilities
Cash and cash equivalents	Current accounts
Sales receivables	Other liabilities
Investment in securities	
Investment in leased assets	
Investment in real estate	Equity of investment accounts
Equity investment in joint ventures	Investment accounts
Equity investment in capital ventures	Profit equalisation reserve
Inventories	Investment risk reserve
Other assets	Owners' equity
Fixed assets	

bank's management in the same investment portfolio, and report these investments and their results in the bank's balance sheet and income statement. Hence, unrestricted IAH funds are far from being "ring fenced" from the bank's own funds.

The relationship between IAHs as providers of funds and the bank in its capacity as fund manager is in most cases regulated by the *mudarabah* form of contract, which has detailed juristic rules derived from the *Shari'ah*.[6] One of the absolute requirements for a valid *mudarabah* is the transfer of control over investment decisions, including all operating policies of the *mudarabah*, from the IAHs to the bank as *mudarib*. IAHs have no right to intervene in these investments and policies, which are the sole prerogative of the *mudarib*. A clear separation must occur between IAHs and their invested capital. However, unlike the situation with shareholders, this separation of capital ownership from management under *mudarabah* as currently applied does not provide any rights of governance or oversight to IAHs in exchange for their funds, as will be elaborated below. Moreover, the *mudarabah*-based structure does not provide the IAHs as investors with the kind of governance rights typically offered by mutual funds, such as a separate legal entity subject to requirements for annual reports, audit, etc. This situation sets the agency perspective of corporate governance of IAHs, which is unique to Islamic banks (see Archer and Karim 2009).

According to Udovitch (1970, 190):

> *This [arrangement] . . . in no way implies a transfer of ownership of the investment capital from the investor to the agent [mudarib]. While the agent's control over the disposition of the investment is almost absolute, its ownership unequivocally remains with the investor [IAH].*

This *personal* form of ownership of the capital and of the assets in which it is invested contrasts with the *impersonal* form of the entity, which is based on "the legal 'separation' of share ownership from ownership of the business assets" whereby "a company is legally the owner of its business assets, and the shareholding members have only the rights that are attached to their ownership of share capital" (Scott 1997, 3). The *mudarabah* concept of the personal form of ownership has implications for the accounting definition of an asset when Islamic banks report, as is currently the practice, on their balance sheets the assets financed by unrestricted IAHs.[7] Furthermore, it is not clear how the underlying assets of *sukuk* (Islamic bonds), which use the *mudarabah* contract to mobilise funds, are to be characterised in terms of this concept of ownership—that is, what kind of ownership claim over the underlying assets is conferred by the *sukuk*.

One of the reasons for the separation of ownership from management in the *mudarabah* is that it is classified as a fiduciary contract, and the *mudarib*

> *. . . is considered a trustworthy and faithful party (amin) with respect to the capital entrusted to him, and therefore not liable for any loss occurring in the normal course of business activities; [however, the mudarib] . . . becomes liable for the property in his care as a result of any violation of this fidelity. (Udovitch 1970, 203–204)*

To fulfil its fiduciary duty, the bank (as *mudarib)* is expected to generate the maximum profit for and to act in the best interests of IAHs (Saleh 1992). Indeed, the primary duty of the *mudarib* is to comply with the trust vested in it when managing the funds of IAHs. This means that the management of the Islamic bank owes a fiduciary duty to two categories of equity holders, shareholders and IAHs, whose interests may not necessarily be congruent. This in turn raises an important issue for the regulation of Islamic banks, namely the attention that needs to be given to their fiduciary duties as fund managers, as opposed to the current focus on their commercial banking aspects.

As a profit-sharing and loss-bearing financial instrument of limited duration, the *mudarabah* contract is neither a financial liability nor an equity instrument in the normal sense. According to Udovitch, it "combine[s] the advantages of a loan with those of a partnership; and while containing elements characteristic of both it cannot be strictly classified in either category" (1970, 171). In fact, *mudarabah* is sometimes described as a "partnership between work and capital," where the provider of capital is the owner of the "partnership" assets. It should therefore be noted that an investment made under a *mudarabah* contract, as an *equity* investment, raises governance issues that do not apply to a loan.

However, unlike conventional equity instruments such as common shares, whose owners can have access to their capital only by selling them, IAHs are entitled to be repaid their capital, which is redeemable at maturity or at the initiative of their holders,[8] but at net asset value, which in the event of losses will be less than the amount invested. This is because the *mudarabah* is a nonbinding contract and "as such either of the contracting parties involved therein may disengage himself at the moment of his choice either because he has lost his confidence in the other contracting party or because the latter has violated the trust, or even for no reason at all" (Saleh 1992, 139). However, the current practice in most Islamic banks is that IAHs (usually) have to secure the prior consent of the bank before they can withdraw their funds before maturity. Islamic banks can refuse to pay IAHs

until the results of the investments financed by IAHs' funds are determined,[9] so that any losses can be taken into account. However, such a practice can expose the bank to reputational risk and impair its ability to attract potential IAHs. A number of Islamic banks maintain reserves against losses on IAH investments, a practice that mitigates the risk of paying out an amount in excess of its strict entitlement to an IAH who withdraws.

As noted above, IAHs lack the governance rights that company law accords to shareholders. They do not have: (1) the benefit of a board of directors to monitor management on their behalf, whose members they appoint and can dismiss; (2) the right to receive an annual report and to appoint external auditors to audit it; (3) the right to take part and vote in an annual general meeting or other general assembly; and (4) the right to participate in appointing the *Shari'ah* supervisory board[10] of the bank. Contractually, IAHs may not "interfere in the management of their funds," and violation of this condition can nullify the contract. This requirement not to "interfere in the management" is (questionably) interpreted as implying that IAHs have no right whatsoever to governance or oversight over the management of their investment. This means that the only possible means by which IAHs can express their dissatisfaction with the bank's performance is to exercise their right to terminate their contractual relationship with the bank and "vote with their feet" by withdrawing their funds.

As already noted, according to *Shari'ah* jurisprudence Islamic banks do not guarantee the value of these investment accounts;[11] nor do IAHs have the powers of creditors, who have a variety of control rights which they obtain when firms default or violate debt covenants, and which include the right in those circumstances to interfere in the major decisions of the firm.[12] Their residual claim on the earnings or assets that relate to their funds after paying any creditors for debts that have been contracted specifically on behalf of the IAH, but not other creditors such as the current account holders, ranks similarly to the residual claim of the shareholders on the bank's earnings or assets after paying any creditors other than those with claims on the assets of the IAH, for example current account holders (see Karim 2011).[13] Moreover, while the *mudarabah* contract is neither a debt nor a conventional equity instrument, neither is it a type of conventional hybrid instrument comprising debt and equity characteristics. (For example, it is *not* debt with an embedded equity derivative.)

In the unrestricted type of *mudarabah*, IAHs authorise the bank to invest their funds at its discretion, including commingling the IAHs' funds with those of shareholders. In the restricted *mudarabah*, in principle IAHs specify to the bank, among other conditions,[14] the type of investment in which their funds should be invested—for example, real estate, currencies, leasing, and so on. In practice, Islamic banks offer a variety of "off-the-shelf"

mudarabah investment funds, each with a specified (restricted) type of asset allocation, from which investors may choose. Hence, although holders of both types of investment accounts are exposed to different degrees of risk, their relationship with the management of the bank is subject to the same (very weak, not to say nonexistent) monitoring arrangements provided by the *mudarabah* contract, as currently practiced by Islamic banks.

The aggregate investment portfolio of an Islamic bank is usually financed by unrestricted IAH funds, plus shareholders' equity and funds from other sources (for example, current accounts), the latter being mobilised on bases other than the *mudarabah* contract. If the aggregate investment portfolio yields a positive return, then the shares of profit are first allocated between the parties to the contract, IAHs, and the bank, according to their proportionate shares of their respective investments in the portfolio. The IAHs' share of profit is then allocated between the IAHs and the bank (in its capacity as a *mudarib*) according to a predetermined percentage. The bank is also entitled to any profit earned from investing the funds provided by current accounts.

The bank's share of profit relates to both its shareholders' funds and to other funds invested in the investment portfolio that do not participate in profit sharing (for example, as noted above, current accounts which are capital-protected but nonparticipating).[15] It is to be noted that shareholders' funds invested in the investment portfolio (and elsewhere) and the other nonparticipating funds are not covered by the *mudarabah* contract, and are not governed by its rules. Hence, the bank's shareholders receive the entire profit from these sources, and IAHs cannot claim any profit share from them. Typically, the *mudarib* share of profit allocated to the bank for managing IAH funds also constitutes a most important source of income to the bank's shareholders.

If the bank's aggregate investment portfolio yields a negative return, then, according to the *mudarabah* contract, this loss should be borne by IAHs and shareholders *pro rata* to their respective investments in this portfolio, bearing in mind what was said in the previous paragraph. Like that of shareholders, the liability of IAHs is limited to the amount of their investment and no more. In the case of a negative return, in addition to the shareholders' proportion of the loss that is determined *pro rata* as indicated previously, the bank in its capacity as *mudarib* receives no profit-sharing fee on behalf of its shareholders (the *mudarib* share of profit having a lower bound of zero). However, according to the *mudarabah* contract, if the loss is due to misconduct or negligence of the *mudarib*, then the Islamic bank has to make good the loss.[16] This exposes the bank to fiduciary risk (which does not appear to be a major consideration in the regulation and supervision of Islamic banks, although in a few countries the supervisory body places

considerable emphasis on the banks' duty to provide a return to IAH and to avoid exposing their funds to losses). In case of losses, the bank is likely to face reputational risk. As yet, however, in the absence of judicial findings it is far from clear what would constitute "misconduct or negligence," and in particular how serious a lack of due diligence would have to be in order to be so classified. In general, this would be a matter for the secular courts to decide based on the applicable law of contract.[17]

3. CORPORATE GOVERNANCE ISSUES IN ISLAMIC BANKS

As already noted, the characteristics of Islamic banks imply that the management has a fiduciary duty to two categories of equity holders: shareholders and IAHs. The fiduciary duty that management owes to the shareholders in an Islamic bank does not differ from that in any other organisation. The fiduciary duty that the bank, represented by its management, owes to IAHs is governed (in most cases) by the *mudarabah* contract. However, judging by the position in other organisations,

> *The standard law and economics view regarding fiduciary duties is that corporations and their directors owe fiduciary duties to shareholders and to shareholders alone. (Macy and O'Hara 2003, 94)*

This places the management of an Islamic bank in a difficult position of potential conflict of interests, which significantly complicates the corporate governance of these banks. Vogel and Hayes (1998, 133) also showed appreciation of this dilemma by wondering, "How can equity be ensured between the shareholders who are investors in the bank, on the one hand, and depositors who are investors in *mudarabah* funds managed by the bank, on the other?" Indeed, it is believed that:

> *The confusion of . . . trying to . . . require directors to balance the interests of various constituencies without according primacy to shareholder interests would be profoundly troubling . . . If directors are required to consider other interests as well, the decision-making process will become a balancing act or search for compromise. (ABA Committee on Corporate Laws 1990, 2253)*

Although IAHs are equity holders and residual claimants, and the bank in its capacity as a *mudarib* owes them a fiduciary duty that should rank equally to that owed to the shareholders, IAHs appear to be the party whose

rights might be compromised. This appears to be due not to the governance characteristics of the *mudarabah* contract as such, but rather to the context in which it is currently used in Islamic banking. If the *mudarabah* contract were used to mobilise funds in a collective investment scheme, the scheme manager would accord primacy to the interests of the holders of the *mudarabah* certificates, because they would be the owners of the fund. However, it is the use of the *mudarabah* contract to mobilise funds by Islamic banks *in the context of a legal entity that has its own shareholders* that appears to put the management of the bank in an ethical dilemma when it is faced with a conflict of interests between the two categories of equity holders. Since it is the shareholders who have the right to appoint, evaluate, and dismiss the management of the bank, this has the effect of relegating the status of IAHs (particularly unrestricted IAHs) to that of "second-class" equity holders. It is also an anomaly insofar as their status as residual claimants on the assets financed by their funds (just as the common shareholders are the residual claimants on the assets financed by other funds) should entitle them to the rights of governance, which, for good reason, normally attach to that status (Williamson 1996, Chapter 12). Thus, in the event of a conflict of interests between them and the common shareholders, the IAHs are clearly at an important disadvantage.

This raises the following fundamental question: Why do unrestricted IAHs place their funds with Islamic banks to manage these funds on their behalf as equity investors, while they do not get any governance rights in exchange for their funds and the risk they bear, but only the hope that they will receive a return on those funds? While, as Shleifer and Vishny (1997) point out, the same question may be asked in respect of equity investors (and especially minority shareholders) in other organisations, the situation in the case of unrestricted IAHs is worse. They are denied any governance mechanism that could serve to safeguard their interests and to mitigate potential conflicts of interests between them and the common shareholders (that is, between two categories of principals) on the one hand, and between them and the bank's management as the agent both for them and for the common shareholders on the other hand.

One possible explanation is hypothesised by Archer, Karim, and Al-Deehani (1998) who pose the question: How may IAHs influence the behaviour of the bank's management in order to safeguard their own interests within the terms of the *mudarabah* contract? Archer and colleagues (1998) suggest that IAHs may be able to safeguard their own interests by relying on shareholders' monitoring to operate on their behalf, if it can be assumed that there is no significant conflict of interests between the two parties. They call this "vicarious monitoring." In many cases, both shareholders and IAHs face the same portfolio investment risk insofar as the funds

of both parties are commingled and invested in the same investment portfolio, this being so in many Islamic banks. Accordingly, it would seem that the IAH could expect a gross rate of return not less than the minimum that shareholders would expect to earn from investing their funds in a portfolio of projects of the same degree of risk.[18] (Both IAHs and shareholders must meet certain expenses out of their gross returns; in the case of IAHs, the major expense is the *mudarib* share of profit to be paid to the bank.) On the other hand, if the aggregate investment portfolio yields a negative return, both parties lose part of their equity. In addition, shareholders receive no *mudarib* share from the bank's managing the IAHs' funds, although this can never be negative. (Assuming risk-neutrality of both parties, this asymmetry with respect to the *mudarib* share would not result in any conflict of interest. However, this may be a strong assumption. In particular, unrestricted IAHs, who typically view their accounts as a *Shari'ah* compliant alternative to conventional deposit accounts, are likely to be more risk-averse than shareholders.)

Moreover, even if the two sources of funds are neither commingled nor invested in the same investment portfolio, the characteristics of the *mudarabah* contract would arguably tend to produce goal congruence rather than conflict of interest between the two parties, notably because the IAHs can "vote with their feet" and withdraw their funds if dissatisfied with their return. Through the *mudarib* share of profit mechanism, shareholders stand to gain from any profit earned from investing IAH funds. The *mudarib* share of profit constitutes a valuable source of earnings to shareholders, particularly as it is a reward for the managerial effort of the bank that shareholders earn without (in principle) incurring any risk to their equity (see Al-Deehani, Karim, and Murinde (1999). This suggests that in order to maintain their return from this source of earnings, shareholders would have an interest in employing a management performance measure whereby the management of the bank would be expected to achieve a satisfactory rate of return on IAH funds—that is, a rate commensurate with the market rate of return earned by financial instruments having a similar level of risk. Achieving this would tend to motivate the existing IAHs to maintain their investments with the bank, as well as to attract other potential IAHs. On the other hand, if the aggregate investment portfolio yields a negative return, then shareholders would receive a *mudarib* profit share of zero. This would also tend to affect negatively the returns of shareholders in future periods, because existing IAHs would be tempted to shift to other investment opportunities and potential IAHs would be discouraged from investing in the bank.

However, the hypothesis of Archer, Karim, and Al-Deehani (1998) involves an assumption that shareholders have the ability to exercise the type of effective control of the bank's management that would serve to safeguard

IAH interests. According to Shleifer and Vishny (1997), there are a number of corporate governance mechanisms that suggest such an assumption is problematic. This would apply in situations where there are either diffuse shareholders or concentrated ownership.

In setups where there are diffuse shareholders, management is likely to have significant discretion over the control of corporate assets. Indeed, there are a variety of factors that keep diffuse shareholders from effectively exerting corporate control. For example, there are large informational asymmetries between management and diffuse shareholders. Also, diffuse shareholders frequently lack the expertise and incentives to close substantially the information gap and to monitor management. Indeed, a cursory review of the financial reports of Islamic banks reveals that diffuse shareholders as well as IAHs get a minimum amount of disclosure of information about the actual returns to IAHs and the extent to which the returns paid out are subjected to smoothing, the risk profile of the assets in which their funds are invested, and other relevant information that would help them in their decision making. In addition, managements of Islamic banks have significant discretion over the control of IAH assets, particularly in the case of unrestricted IAHs.

Furthermore, management may capture the board of directors because the board does not often represent the interests of diffuse shareholders. Indeed, "as ownership becomes more diffuse, managers can more easily manipulate information, form alliances with different groups, and capture control of the firm" (Caprio and Levine 2002, 5). This also has an effect on the extent to which the corporate governance problem can be solved by the use of incentive contracts. In the case of Islamic banks, it is uncertain whether the board of directors would represent the interests of IAHs. Rather, it is more likely that the board would cater for the interests of the shareholders, who normally have representatives on the board. For example, Bahrain Islamic Bank disclosed in its 2003 annual report that it will no longer allow its IAHs to share in the returns generated from investing funds available from current accounts, as was the case in the past, because this is the exclusive right of the shareholders who bear the risk while the IAHs do not. (A share of such returns may have been paid to IAHs in the past when management felt that otherwise their level of return would be uncompetitive.)[19]

Islamic banks tend to be opaque about the bases on which management incentive contracts are established: is it on the total investment income earned by the bank before the allocation to IAHs of their share in that income, or is it the investment income (including the *mudarib* share) earned for the shareholders? If it is the latter, which is most likely the case, then management would have an incentive to manipulate that amount in order to

maximise it (and, hence, their incentive pay), which would also coincide with the interests of the shareholders.

On the other hand, if ownership is not diffuse, while large investors have the incentive to collect information, to monitor management, and to exert control over managerial decisions, these activities have their cost, too, and are not without their drawbacks. As Shleifer and Vishny (1997) point out, large investors act in accordance with their own interests, which may be at the expense of other investors and stakeholders. This could also have unfavourable consequences on the firm's resource allocation. In addition, large investors are likely to get preferential treatment at the expense of other investors and stakeholders. They may influence dividend policy or cause the firm to engage in related party transactions, in ways that benefit them to the detriment of the firm's other shareholders (Dann and DeAngelo 1985) and IAHs.

Such actions are also mirrored in the behaviour of some Islamic banks. For example, we have observed instances of the following. There are Islamic banks that have attempted to pay shareholders a constant high rate of dividends for a long period, while IAHs in those banks were receiving minimum returns. This apparently was due to manipulation of the formula by which profits were allocated between IAHs and the shareholders, and of the manner in which certain expenses were charged to IAHs. In addition, in certain Islamic banks, management tend to please the board of directors, which is controlled by a few large shareholders, by "cherry picking" the more attractive projects (in terms of risk and return) for investment mainly from shareholders' funds, while IAH funds are used to finance inferior projects.[20] This type of behaviour by management appears to be influenced by the timing of the renewal of management's contract—a matter in which common shareholders, but not IAHs, have a say. These factors can have as a consequence a rate of return on unrestricted IAHs funds that is *only about 10 percent* of the rate of return on shareholders' funds.

Another issue concerned with shareholders (through management) being benefited at the expense of IAHs relates to what are known as the profit equalisation reserve (PER)[21] and the investment risk reserve (IRR),[22] the purpose of which is to smooth IAH income and cover IAH losses, respectively. In the contract that regulates their relationship with the bank, IAHs agree in advance on the proportion of their income that may be allocated to both reserves, which (subject to this) is determined by the management of the bank at their own discretion. In the same contract, IAHs also agree to give up any right they have to these reserves when they terminate their contractual relationship with the bank. It should be noted that before Accounting and Auditing Organization for Islamic Financial Institutions promulgated its Financial Accounting Standard No. 11, *Provisions*

and Reserves (1999b), no Islamic bank had disclosed information in its annual report on the smoothing of IAH profits (or covering of losses) or by how much.

Prior to the development of the concept of the PER, Islamic banks used to enhance the returns of IAHs to match the competitive returns in the market by donating the amount needed to smooth the returns of IAHs from the bank's *mudarib* share. The low rate of return on IAH funds could be due to the investment of these funds in assets with a relatively long maturity (for example, *murabahah* or *bay' bithaman ajil)* with a fixed rate of return that falls short of the rate currently available in the market on comparable instruments,[23] a circumstance analogous to an adverse interest rate mismatch in a conventional bank.

The shareholders' decision to agree (which is a *Shari'ah* condition) to give up part or all of their profits to enhance IAH returns means that the shareholders accept that the risk attaching to the returns of a portfolio of assets financed partly or wholly by IAH funds is "displaced" so that it is borne largely by themselves (the shareholders).[24] (In the case of conventional deposits, the risk of the assets in which the depositors' funds are invested is, of course, totally borne by the shareholders.) Failure to smooth the IAH returns might result in a volume of withdrawals of funds by IAHs large enough to jeopardise the bank's commercial position. On the other hand, smoothing the IAH returns is unlikely to attract adverse attention by the banking supervisor, because it would reduce the danger of the bank being a source of systemic risk through a run by IAHs (see Archer and Karim 2012). Indeed, in some countries (for example, Qatar and Malaysia) the banking supervisor takes the view that Islamic banks should not allow unrestricted IAHs to suffer a loss of their capital or a major fall in their returns. In this sense, the displacement of risk on to the shareholders might be thought of as being, in part, a type of "political cost" that shareholders incur in order to avoid falling foul of the industry regulator. While this practice may occur in relation to the funds of restricted as well as unrestricted IAHs, it is particularly problematic in the case of the latter whose funds are commingled with those of the bank's own (common shareholders') funds.[25]

Such a practice might be considered to support the "vicarious monitoring" hypothesis suggested by Archer, Karim, and Al-Deehani (1998), in the sense that shareholders are willing to sacrifice part or all of their *mudarib* share in the short term in order to compensate IAHs for an inadequate level of return on the assets in which their funds are invested. This would have the effect of encouraging the IAHs to continue investing their funds with the bank because (as pointed out by Al-Deehani, Karim, and Murinde 1999) such continuity is very much in the interest of the shareholders, particularly if unrestricted IAH funds represent 60 percent or more

of the funding side of the bank's balance sheet, which is the case with many Islamic banks.

It was to mitigate the effects of this practice, which could not be sustained in the longer term if the shareholders had consistently to forgo the bank's *mudarib* share, that the management of many Islamic banks introduced the profit equalisation reserve (PER). While the declared objective of the PER was to reduce the volatility of IAH returns, it provided management with a mechanism to tap this pool of funds to relieve shareholders of the burden of smoothing the returns of IAHs or to mitigate problems of asset–liability management. In fact, as with earnings management techniques in general, a major objective is to reduce transparency and management accountability,[26] in this case to the detriment of IAHs, since while the amount by which the returns of IAHs are smoothed from the PER creates value for shareholders, it does not do so for IAHs (Archer and Karim, 2004). In fact, it represents a cost (in terms of foregone returns while the reserve is being built up), which IAHs incur if they invest their funds under a form of *mudarabah* contract that permits management to retain a proportion of the profit share in order to build up a PER that would otherwise have been paid out to them.

Similar considerations apply to the investment risk reserve (IRR). In addition, the IRR may give rise to moral hazard problems similar to those arising from deposit insurance schemes, since the existence of IRR in Islamic banks is likely to encourage management to engage in excessive risk taking. This is because losses can be covered, at least in part, by this reserve, which is financed only from the funds of IAHs and not those of shareholders, and this is likely to increase the management's risk appetite to a higher level than that of the IAH. This is especially the case since the IRR is appropriated from profits *after* the calculation of the *mudarib* share, which is unaffected, while in the case of a loss the *mudarib* share is zero, irrespective of the size of the loss. Even if a loss absorbed by the IRR were due to misconduct and negligence, in which case according to the *mudarabah* contract it should be borne by the shareholders, it would be difficult for IAHs to be aware of this because of the absence of either adequate disclosure or other means to detect such a loss. In addition, as noted above, it is unknown to what extent the legal system in the countries in which Islamic banks operate would support the right of IAHs to be compensated for such losses in such cases. The criteria for proving negligence may be hard to satisfy, and the same may be said of misconduct if there is no clear breach of contract.

Hence, while the lack of any governance structure in the *mudarabah* contract may leave IAHs dependent on shareholders to monitor the performance of the management of the bank, the existence of PER and IRR is likely (and is arguably intended) to conceal from IAHs lapses in that

performance, and more generally the need for them to seek other corporate governance mechanisms (see Archer and Karim 2006). In fact, smoothing the returns and absorbing losses through these reserves have the effect of making the returns on IAHs behave more like those on conventional deposits—that is, a debt instrument. This effect will likely continue as long as there are adequate balances in both reserves to reduce the volatility of the returns of these account holders and to act as a buffer to absorb losses before they are seen to erode the equity of IAHs. Such a situation is furthermore sustained by, and also contributes to, both weak market discipline, which tends to exist in almost all countries in which Islamic banks operate, and a lack of transparency (which is a common feature of banks in general, and of Islamic banks in particular).

More generally, the fact that unrestricted IAHs tend to be risk-averse savers while shareholders will typically have a greater risk appetite, implies the likely existence of incentive misalignment between IAHs and shareholders, which casts doubt on the existence or effectiveness of "vicarious monitoring."

Another implication of the PER (and of the lack of transparency) is that it would distort competition among Islamic banks, in the sense that IAHs would not see the need to withdraw their funds, which is the only means available for them to discipline Islamic banks, as long as IAHs receive a (smoothed) rate of return on their investment that is commensurate with the going market rate (see Archer and Karim 2006b). Furthermore, the existence of the IRR would reduce the ability, if not the incentives, of IAHs and shareholders to monitor the bank's performance, and thus would negatively affect market discipline. This is similar to one effect of deposit insurance schemes, which is to reduce the incentives of depositors to monitor banks, while subordinated debt holders, to the extent that they believe the existence of central banks as lenders of last resort might protect them, also have their incentive to monitor the bank curtailed (Caprio and Levine 2002).

The theme emerging from the foregoing analysis of corporate governance of Islamic banks suggests that, although the management owe IAHs a fiduciary duty similar to that of shareholders, the rights of the former are likely to be compromised because of their weak governance rights and structure compared to the shareholders, even though both are equity holders and residual claimants on the assets held or managed by the bank. Furthermore, although IAHs may depend to some extent on shareholders to safeguard their interests, the above analysis suggests that such reliance has significant limitations so that, far from serving the interests of IAHs, and particularly those of unrestricted IAHs, current practice in profit smoothing and the use of reserves for that purpose involve a lack of transparency that

aggravates their exposure to conflicts of interests and inhibits the development of market discipline.

Indeed, the current status of unrestricted IAHs appears fundamentally anomalous from a corporate governance perspective. Not merely is "vicarious monitoring" unlikely to be very effective, for the reasons just explained, but in the circumstances in which it is most likely to be effective—that is, full commingling of shareholders' and IAH funds—there is also the greatest likelihood of conflicts of interests regarding risk appetite. However, such limitations seem not to have affected the magnitude of IAH funds in Islamic banks, in some of which they represent a high percentage compared to other sources of funding (see Exhibit 21.2, and also Exhibit 2 in Al-Deehani, Karim, and Murinde 1999).

For restricted profit-sharing investment accounts (PSIA), data for only seven banks was available consistently for these years. Therefore, based on the data submitted by the IIFS, the following are the average percentages of restricted PSIA (out of total assets) for these years (see Exhibit 21.3).

In effect, unrestricted IAHs seem to behave very much like depositors in conventional banking, rather than like a category of equity investors: They are passive and risk averse, being content with very modest rates of return compared to those available to shareholders. *But they do not have the status of creditors and the attendant governance rights in case of default*. In fact, it is not even clear what would constitute default in regard to the Islamic bank's obligations to them; this would seem to be restricted to cases of misconduct or negligence, as mentioned in Section 2 earlier.

EXHIBIT 21.2 The Average Percentage of Unrestricted PSIA (out of total assets) for 44 Banks for Years 2007–2009 and the First Half Year 2010

First Half of 2010	2009	2008	2007
49.32%	46.77%	43.58%	40.00%

EXHIBIT 21.3 The Average Percentages of Restricted PSIA (out of total assets) for 2007–2009 and the First Half Year 2010

First Half of 2010	2009	2008	2007
16.58%	15.33%	14.43%	15.40%

With this background, the next section examines the extent to which IAHs could impose effective market discipline on Islamic banks, and insofar as the abilities of IAHs to achieve this objective are limited, Section 5 discusses the approach to the regulation of Islamic banking that may be relevant in light of the initiative taken by a number of central banks and monetary agencies to develop prudential and supervisory standards that cater for the specificities of Islamic banks.

4. EXERCISING EFFECTIVE MARKET DISCIPLINE ON ISLAMIC BANKS

The 2004 BCBS's *Revised Framework* (Basel II) took the view that market discipline is increasingly important in a world where banking activities were becoming more and more complex. This is also included in the recently issued BCBS post-crisis Framework, known as Basel III. Thus, both Pillar 3 of Basel II and Basel III encourage greater bank disclosure to strengthen market discipline.

According to Belkhir (2012), "The recent financial crisis has, however, battered the belief in the effectiveness of markets to discipline bank risk, as many voices pointed to the failure of market mechanisms in preventing banks from taking excessive risks." Furthermore, "while the lack of market discipline has been pointed out as one of the main reasons for the excessive risks taken by banks in the pre-crisis years, others argue that market participants cannot be effective in curbing banks' excessive risk-taking in the presence of implicit guarantees, such as the too-big-to-fail guarantee" (Belkhir 2012).

According to Crockett (2001, 3), for market discipline to be effective four prerequisites have to be met: "First, market participants need to have sufficient *information* to reach informed judgments. Second, they need to have the *ability* to process it correctly. Three, they need to have the right *incentives*. Finally, they need to have the right *mechanisms* to exercise discipline." In what follows, an attempt will be made to examine the extent to which IAHs qualify for Crockett's prerequisites for imposing effective market discipline on Islamic banks.

The hypothesis suggested in Archer, Karim, and Al-Deehani (1998) assumes that one of the factors that would give IAHs comfort is that these investors are aware, among other things, of the commingling of their funds with those of shareholders and of the proportions in which the portfolio of assets is financed by IAHs and shareholders, respectively, and how the banks calculate the allocation of profit sharing between the two parties.

However, as noted by Archer and colleagues (1998), these assumptions are problematic given the lack of adequate disclosure by Islamic banks which results in major information asymmetry between IAHs and the bank's management, as described next.

Prior to the establishment of AAOIFI, the lack of adequate disclosure by Islamic banks was very apparent. This may have been due to a lack of appreciation of the financial reporting requirements with which Islamic banks should comply in order to provide adequate disclosure to IAHs in their capacity as equity investors, not depositors. Indeed, a cursory review of the annual reports of Islamic banks prior to the implementation of AAOIFI's standards reveals that Islamic banks were hardly required to disclose any information relating to the investment of IAH's funds—for example, (i) the type of assets in which the funds of these account holders are invested, (ii) the risks to which they are exposed and how the bank manages those risks, (iii) the bases of allocation of profits between the bank and IAHs, including the type and amount of expenses that the bank charges to their accounts, (iv) whether either of the two types of investors (IAHs or shareholders) is given priority in placing liquid funds available for investment, and (v) whether the returns of IAHs are smoothed and if so by how much, and so on.

Islamic banks were also divided as regards the accounting treatment of IAHs on their balance sheet. Some banks reported unrestricted IAH funds on the balance sheet under liabilities,[27] while others treated them as part of equity. Yet a third group of banks treated all IAH funds as off-balance sheet items. Karim (2001) argues that these differences were due to the approaches adopted by various countries to regulate Islamic banking.

Such a lack of transparency meant that there was considerable information asymmetry between IAHs and the management of the bank, which prevented the former from being adequately informed about the performance of their investments and at the same time provided the management with enough freedom to favour shareholders (to whom they are accountable via the board of directors and the annual general meeting) at the expense of IAHs (particularly unrestricted IAHs), who have no such governance rights. On the other hand, with the exception of the accounting and governance standards issued by AAOIFI to enhance the transparency of matters relating to IAHs, very few regulations were promulgated by authorities in the countries that host Islamic banks to address the corporate governance issues raised by the existence of this type of equity investor. In addition, while anecdotal evidence suggests that the standards prepared by AAOIFI have created much awareness of corporate governance issues relating to IAH, their impact has been greatly restricted by the fact that only a limited number of countries have adopted these standards, and that even in those countries compliance with them is patchy (see Mustafa 2003).

However, to improve corporate governance for IAHs through disclosure requires a cross-sectoral approach to the regulation of the institutions that accept these investment accounts (Karim 2011; Archer and Karim 2012). Such an approach draws, *inter alia*, upon securities regulation, which requires that adequate attention should be given to investor protection (which does not mean a guarantee of capital, but providing investors and prospective investors with full disclosure of information both before and after they make any investment, whereby they are better able to assess the potential risks and rewards of their investments and, thus, to protect their own interests).

As will be discussed later, almost all supervisors have approached the regulation of investment account holders from the perspective of depositor protection rather than investor protection[28] (see also Archer and Karim 2004; 2012; Karim 2011), and this appears to have placed the regulation of these accounts solely in the hands of the banking regulators, with hardly any involvement by the securities regulators who tend to be unaware of either the complexities or the disclosure requirements of IAHs in Islamic banks.

On Crockett's second prerequisite—namely, the need to have the *ability* to process the information correctly—suffice it to say that the complexities of the operations of Islamic banks are hardly understood even by many in the industry. Indeed, not many would be familiar with the inherent risks of the contracts used by Islamic banks in both the utilisation and mobilisation of funds. For example, until AAOIFI published its accounting standard on leasing, almost all Islamic banks—with the approval of their external auditors—invariably used to treat *ijarah muntahia bittamleek* (IMB)[29] as a finance lease, although according to the *Shari'ah* provisions of the contract the lessor is not allowed to transfer substantially all the risks and rewards of ownership to the lessee. From the perspective of the Basel II and Basel III requirements, the treatment of IMB by Islamic banks prior to AAOIFI's standard would mean that the banks entering into such a contract as lessor would be exposed only to credit risk. However, according to both the *Shari'ah* precepts of the contract and its substance, the bank as lessor under IMB would be exposed to a significantly higher level of operational risk than a lessor under a conventional finance lease (as well as being similarly exposed to price risk on the value of the asset as quasi-collateral, subject to "haircuts"), and hence should be expected to provide regulatory capital to cater for these risks, an issue that is challenging for supervisors of Islamic banks (see also Archer, Karim, and Sundararajan 2010).

Another example relates to the *salam* contract, which exposes the Islamic bank to both credit risk and commodity price risk as the bank agrees to buy the commodity on a future date against current payment and also holds the commodity in question until the bank can convert it into cash,

unless it has entered into a parallel *salam* contract. The latter contract enables the bank to hedge against price risk, but only partially because the *Shari'ah* provisions of the contract prohibit making the execution of the parallel *salam* contract dependent on the execution of the original *salam* contract. In this case, AAOIFI's Standard No. 7 on *salam* and parallel *salam* specifies that the underlying asset of the contract should be measured at lower of cost and market price when it is received by the bank. However, if the customer defaults on its obligation to deliver the commodity to the bank, the latter has nevertheless to fulfil its obligation in the parallel *salam* by acquiring the commodity from the market, which exposes the bank to price risk (in addition to the inherent credit risk) in the event of such default.[30] On the other hand, if the bank does not enter into a parallel *salam*, it is fully exposed to price risk on its "long position" in the asset, which it would sell after its delivery on the maturity of the contract.

The lack of appreciation of, among other things, the intricacies of both risk management and financial reporting relating to the operations of Islamic banks by IAHs and other consumers of the Islamic banks' services, together with the lack of adequate disclosure, indicate that neither of Crockett's first or second prerequisites is satisfied in order for market discipline to be effective in the case of these banks.

Crockett's third and fourth prerequisites regarding the right incentives and mechanisms can best be addressed by looking at the similarities and differences between subordinated debt and IAH funds (see Archer and Karim 2006b). There have been proposals (for example, Evanoff and Wall 2000; Hamalainen 2004) to ask banks to incorporate subordinated debt into their capital as an additional financial cushion, as this is "one of the most effective market mechanisms for relaying information about a bank's risk profile . . . [This is because] subordinated debt holders . . . do not profit from a bank's risky investments if those investments turn out to be profitable, but they stand to lose their money if those investments are not profitable. For that reason, holders of subordinated debt would have a very strong incentive to monitor closely the activities of banks" (Rodriguez 2002, 18). Indeed, subordinated debt (subject to certain conditions regarding maturity and risk absorption) may be accepted as part of banks' regulatory capital under Basel III.

IAH funds share several features of subordinated debt, including, most importantly, the subordination of their claims to those of creditors relating to debt contracted specifically on behalf of IAH by the bank. Also, unlike conventional depositors, neither holders of subordinated debt nor IAHs are in a position to initiate a conventional bank run, and stand to lose part or all of their capital if their investments yield negative returns. This provides holders of both instruments with incentives to monitor the bank's choice of

risk, especially as both instruments may be used as a means of leveraging the shareholders' returns (in the case of IAHs, because of the *mudarib* share of profits—see Al-Deehani, Karim, and Murinde 1999). IAHs are entitled to profits that are related to the investment of their funds, which may or may not be commingled with the bank's own (shareholders') funds. If IAH funds are commingled with shareholders' funds in the same pool of assets, they are likely to constitute the larger share of the investment in the asset pool, but the choice of asset allocation may reflect management's view of shareholder preferences in terms of risk–return characteristics. Hence, there is always an incentive for the management of both conventional and Islamic banks to increase risk through leverage using subordinated debt or IAH funds, respectively, because the shareholders in both types of banks will benefit fully when the banking business is successful. Shareholders may benefit more from the "upside" of risk to which there is no firm upper bound, but may not be exposed proportionately to the "downside," which is limited to the loss of their own (but not IAHs') capital.[31] In certain circumstances, such as incipient financial distress, this may provide management with a motive for taking excessive risks (that is, "betting the firm").

In case of a bank failure, the losses of the shareholders in both types of banks are limited to their share in the bank's capital, and holders of subordinated debt in conventional banks have a claim on the assets of the banks that ranks after those of other creditors but before that of shareholders. Unrestricted IAHs, on the other hand, rank after all creditors that have been contracted specifically on their behalf, and in the case of commingled funds they have the residual claim on the proportion of the asset pool that was financed by their funds.

However, in contrast to holders of subordinated debt, IAHs lack a mechanism whereby they contribute significantly to effective market discipline—namely, a *quoted market price* that reflects the market's view of the bank's financial position. Subordinated debt bonds are tradable in the financial markets, and their yields provide the market's assessment of the risks taken by the banks. "This implies that the supervisor will get an early warning signal, either through a higher required risk premium by the investors or though trouble when issuing new bonds. So the holder of the bond will have the incentive to monitor the bank continuously, strengthening the market discipline" (Sijben 2002, 61). These mechanisms, however, are not available to IAHs because their investments are not tradable in the capital markets. Hence, IAHs lack this means of signalling to the market their assessment of the risks taken by the Islamic bank and thus putting pressure on the bank's management via the capital market as indicated above.

Furthermore, while IAHs, like any investors, are expected to monitor the bank's choice of risk because their capital is exposed to losses, the lack of adequate disclosure of relevant information makes this a difficult task for IAHs, thereby further reducing their ability to exercise effective market discipline. This may encourage Islamic banks to increase their risk to a level in excess of the risk appetite of IAHs, especially since the latter are not in a position to require a higher risk premium on their investment; their only recourse is to withdraw their funds, subject to a loss of accrued profit share if they do not observe the waiting period set out in their *mudarabah* contract.

In addition to the availability of adequate information to gauge the riskiness of the bank by depositors, Blum (2002) and Cordella and Yeyati (1998) argue that a conventional bank's risk choice will be efficient if the bank deposits are uninsured. This is so because banks take account of the impact of their risk choice on depositors, since they will demand higher compensation should the bank incur higher risk. However, if deposits are insured or the bank's risk choice is not observable by depositors, the bank will increase risk at the expense of depositors (Baumann and Nier 2003).

Although contractually IAHs are uninsured because they bear their own risk of loss, the use of an IRR by Islamic banks may have "safety net" effects for IAHs that reduce their incentives to monitor management.[32] Furthermore, in a number of countries, including some that have a high density of Islamic banks (for example, Bahrain and Sudan), Islamic banks enjoy the benefits of a formal system of *Shari'ah*-compliant (that is, *takaful*-based) deposit insurance. The introduction of deposit insurance is, however, contrary to what is recommended in a report by the World Bank (2001) which calls for developing countries that do not have a formal system of deposit insurance to refrain from establishing one, especially if the institutional environment in that country is weak. In addition to these safety nets, the availability of PER tends to reduce the incentives of IAHs to exercise market discipline because, as argued earlier, they would not see the need to withdraw their funds as long as they received a smoothed rate of return on their investments that is commensurate with the market rate (Archer and Karim 2006b). However, while these measures may potentially curb the incentives of IAHs to monitor the bank's risk choices, they also tend to provide Islamic banks' management with the opportunity to take excessive risk.

From the analysis in this section, it can be appreciated that given their lack of a governance structure, unrestricted IAHs hardly meet Crockett's four prerequisites, which would enable them to impose effective market discipline on Islamic banks. This highlights the emphasis that should be placed on regulating Islamic banks, which is examined in the next section, in

order to enhance, among other things, the corporate governance in these banks with a view to protecting the interests of IAHs.

5. REGULATION OF ISLAMIC BANKS

In almost all cases, Islamic banks are regulated by the central banks in the countries in which they operate. However, there is an absence of commonly accepted regulatory and supervisory guidelines and best practices that cater for the specificities of Islamic banks—for example, the treatment of IAHs in calculating the bank's capital adequacy ratio (see, for example, AAOIFI 1999c; Archer, Karim, and Sundararajan 2010; Karim 1996), the risk weightings of the *Shari'ah* contracts that the banks use to utilise their funds, and so on. Accordingly, central banks have tended to supervise and regulate Islamic banks using the same guidelines as those developed for conventional commercial banks, albeit with some amendments introduced by individual central banks.[33] However, in doing so, central banks appear to have adopted an approach that emphasises *depositor* protection rather than a cross-sectoral approach that combines both *depositor* and *investor* protection to cater for the commercial banking and investment management services which Islamic banks perform (Archer and Karim, 2012).

Contractually, since IAHs bear their own risk of loss, it would not be expected of central banks to protect the equity of these investors by the same methods that they use for depositors such as current account holders, who lend their money to the bank and have a contractual right to redeem their funds in full as and when they demand to do so (or, indeed, holders of conventional "capital certain" deposit accounts). Hence, like investors in collective investment schemes (CIS), IAHs should logically be regulated using the approach of securities regulators, which is more concerned with investor protection and places more emphasis on fiduciary responsibility or establishes detailed regulations designed to monitor potential conflicts of interest facing the managers of a CIS, and perhaps especially the management of an Islamic bank, which may look after the interests of shareholders at the expense of IAHs. In addition, securities regulation would require disclosure of relevant information about the Islamic bank's investment objectives and policies, and operational guidelines that govern the relationship between the bank and IAHs. This would allow IAHs to be in a better position to assess the potential risks and rewards of their investments and, accordingly, to protect their own interests.

However, such an approach to regulation would place the central banks concerned in a dilemma. On the one hand, adopting a securities regulation approach would give a faithful representation of the contractual relationship

between IAHs and the bank, and at the same time give IAHs an incentive to exercise effective market discipline with respect to the bank's management. On the other hand, insofar as IAHs have deposited their funds in a bank rather than investing them in a separate CIS, there would be a possible exposure to systemic risk in the banking system.

More specifically, if IAHs were paid no returns on their investment accounts or low returns compared to the market return on similar instruments as well as bearing the risk of loss, they would be inclined to withdraw their funds, leading to a liquidity crisis for the bank that could have effects similar to those of a conventional bank run. Such a scenario would be of great concern to central banks, because not only might this situation threaten the individual bank's solvency, but it could also trigger systemic risk (which is considerably less evident or nonexistent for the nonbanking financial sector—see, for example, Llewellyn 1999; Dale 1996) in the whole banking sector, thereby threatening the soundness and stability of the financial system in the country.

The risk to an Islamic bank of not earning a rate of return on the assets it manages on behalf of its IAHs that is sufficient to meet their expectations based on current market conditions is an analogue of "interest risk in the banking book" in conventional banks, and is known as "rate of return risk" (see, for example, IFSB 2005). In order to mitigate this rate of return risk, the banking supervisors have allowed or even encouraged Islamic banks to use the PER and IRR, which, as argued earlier, have the effect of weakening market discipline. Moreover, in some countries the banking supervisor has encouraged or even required Islamic banks to treat unrestricted investment accounts as (in substance) capital certain. Such a supervisory requirement results in the investment accounts having *de facto* capital certainty, even though being based on the *mudarabah* (or in some cases the *wakalah*) contract they do not possess *de jure* capital certainty.

It is worth noting that, as with many of their conventional commercial counterparts, the portfolios of assets of the majority of Islamic banks are nonmarketable and are typically held on the balance sheet until maturity.[34] Hence, unlike the majority of CISs, many Islamic banks would not be able to liquidate the majority of their assets in a short time, without incurring substantial (and possibly catastrophic) losses.

6. CONCLUDING REMARKS

This chapter has argued that the profit-sharing and loss-bearing features of IAHs raise specific problems of regulation with respect to Islamic banks. To a considerable extent, profit-sharing investment accounts resemble CISs, yet,

particularly in the case of unrestricted IAHs, their funds are managed within a banking structure by virtue of a *mudarabah* contract which places no "firewalls" between the investment funds and the bank. Unrestricted IAHs are thus a form of limited-term equity investors in an Islamic bank, but have no governance rights other than that of withdrawing their funds (which has the disadvantage of entailing the forfeiting of accrued profit share). Moreover, to minimise the likelihood of their doing this, Islamic banks employ various profit-smoothing techniques, which (like earnings management in general) have the effect of frustrating market discipline.

However, insofar as both Islamic banks and their supervisory authorities in some countries consider unrestricted investment accounts to be a product designed to compete with, and to be an acceptable substitute for, conventional deposits, profit smoothing in such an environment may be considered to be an inherent attribute of the product rather than a means of deliberately avoiding transparency and market discipline, especially if it is combined with in-substance (*de facto*) capital certainly. Indeed, as noted above, in some such countries unrestricted IAHs may benefit from deposit guarantee schemes. Nevertheless, the compliance of some of such practices with *Shari'ah* rules and principles seems open to doubt, to say the least. Moreover, the desire to offer as good a substitute as possible for conventional deposits does not justify obfuscation or a lack of transparency in financial reporting.

The implications of this analysis for financial services regulators are therefore twofold. In the first place, more emphasis needs to be placed on the need for transparency. Considerable improvements in transparency could be achieved by the effective enforcement of AAOIFI's financial reporting standards, which need to be updated on a timely basis as both industry practices and the IASB's international financial reporting standards evolve, and of the IFSB's *Guidance on Disclosures to Promote Transparency and Market Discipline* (IFSB 2009). Second, IAHs need to be considered as investors in need of regulatory protection as such—that is, *investor* protection. Alternatively, if unrestricted IAHs are considered to be virtual depositors, the implications of this in terms of capital adequacy need to be enforced by the supervisory authority (see Archer, Karim, and Murinde 2010)—namely, the treatment of unrestricted IAHs in the same way as liabilities for the purpose of calculating the capital adequacy ratio.

What is clearly unacceptable is that investment accounts, which are juristically profit sharing and loss bearing, should be left with an ambiguous status that allows Islamic banks to finesse transparency, capital adequacy, and investor protection requirements in respect of such financial instruments by treating them as virtual deposits for marketing purposes but as equity instruments (or even off-balance sheet) for the purpose of capital adequacy,

while financial services regulators do not consider them as calling for measures of investor protection.

NOTES

1. *Shari'ah* is the sacred law of Islam. It is derived from the Qur'an (the Muslim holy book), the *Sunna* (the sayings and deeds of Prophet Mohammed), *ijma'* (consensus), *qiyas* (reasoning by analogy), and *maslahah* (consideration of the public good or *common need*).
2. *Riba* is translated strictly as usury, but interpreted by modern Islamic scholars as being equivalent to interest (see Mallat 1988; Saleh 1992; Taylor and Evans 1987).
3. The original form of the *mudarabab* contract is very similar to that of the *commenda* contract in general use by Italian and other merchants in the late Middle Ages and early modern period (see Bryer 1993; Çizakça 1996).
4. *Murababab* is sale at cost plus an agreed-upon margin of profit; *musbarakab* is a form of partnership; *ijarah* is leasing; and *salam* is a purchase of a commodity for deferred delivery in exchange for immediate payment. For more details on these and other contracts, see Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) (2002a).
5. Franks, Mayer, and Correia da Silva (2003) report that in the seven European countries that they surveyed, the regulatory authorities require asset management firms to separate their assets from those of their clients.
6. For a comprehensive coverage of these details see, for example, Udovitch (1970) and Vogel and Hayes (1998).
7. It is worth noting that in order for an asset to be reflected on the balance sheet of an Islamic bank, AAOIFI (1993, para. 22) requires, among other things, that "the Islamic bank should have acquired the right to hold, use or dispose of the asset."
8. In this respect, they are a type of "puttable instrument" as described, for example, in International Accounting Standard No. 32. However, the "put option" (i.e., the right to withdraw the NAV) may be not absolute, but subject to the bank's agreement to its exercise.
9. This is similar to the practice by many mutual funds firms, which prohibit or discourage market timers (investors who rapidly trade in and out of mutual funds) because it is claimed that this hurts buy-and-hold shareholders, as the fund manager has to keep extra cash ready to pay the exiting market timer, which dampens performance. Islamic banks reward IAHs who invest their funds with the bank for a longer period by allocating them a higher profit ratio compared to the profit ratio allocated to IAHs who opt to have access to their funds on demand or invest them for a short period, because the bank, like fund managers, has to make cash available to meet withdrawals by these IAHs.
10. This is a part-time board comprising (usually) three *Shari'ah* scholars appointed (in many cases) voluntarily by almost every Islamic bank to assure its clients

(mainly those who are keen to have their funds managed in accordance with *Shari'ah* rules and principles) that its transactions are in compliance with *Shari'ah* precepts. For more information on this board, see AAOIFI (1999a).

11. According to Saleh (1992, 134), "The reason for the unacceptability of the agent's [*mudarib*] guarantee is that such an agent, likewise any partner, is considered a trustworthy party (*amin*) with respect to the capital remitted to him. He is therefore not liable for any loss occurring in the normal course of business activities, except when there is a breach of trust." However, although "the capital provider is permitted to obtain guarantees from the mudarib [to which the former can have recourse] . . . in cases of misconduct, negligence or breach of contract on the part of the mudarib" (AAOIFI 2002b), this seems not to be practiced by Islamic banks in their current dealings with IAHs.
12. The *Shari'ah* provides that, in case of proven misconduct or negligence on the part of the *mudarib* in a *mudarabah* contract, the funds become a liability of the *mudarib*. Not merely does this not cover normal cases of default; it raises significant problems of enforcement—for example, in proving misconduct or negligence.
13. For more details, see Al-Deehani and colleagues (1999).
14. For other types of restrictions, see AAOIFI (1993, paras 12, 13).
15. Shareholders receive the profit generated from investing the other sources of funds because, in case of loss, providers of these funds are compensated from the shareholders' equity.
16. For more details see Udovitch (1970) and AAOIFI (1996, 1997).
17. See, for example, *Shamil Bank of Bahrain EC v Beximco Pharmaceuticals Ltd.* (2004, EWCA Civ. 19) which did not concern "misconduct and negligence" but the application of a *murabahah* contract where U.K. law was stipulated as the governing law.
18. According to Udovitch (1970, 171), "the investor [IAH] might calculate that a larger total sum in the venture would increase the opportunities of profitable trading activities, or he might feel that the agent's [Islamic bank's] direct financial stake in the transactions would make him at once more cautious and more enterprising." See also Al-Deehani and colleagues (1999) for more details on the theoretical underpinnings of this proposition, and also Williamson (1996) on "hostage posting."
19. This is not the case, for example, in Kuwait Finance House, where the method of allocating profits between IAH and the bank pools the revenues, including those generated from investing the excess of current accounts, and expenses. The residual is allocated between the IAH and the bank. However, the pool does not include the revenues and expenses relating to investments solely funded from the shareholders' funds.
20. If it were the case that the management placed IAH funds in less risky investments which nevertheless offered a competitive rate of return on a risk-adjusted basis, then there would be no grounds for critisism. Given the lack of transparency, however, it is hard to know whether this is the case.
21. PER is an amount set aside from the income of both IAHs and shareholders before the allocation of the bank's share as a *mudarib*. The IAHs' share of the

PER is used to smooth the profit of IAHs to match the returns of instruments in the market, thereby encouraging IAHs to retain the funds with the bank to manage them on their behalf. The shareholders' share of the PER is a component of the reserves within the shareholders' equity (AAOIFI's Financial Accounting Standard No. 11, *Provisions and Reserves* 1999b).

22. IRR is an amount set aside from the income of IAHs, but not the shareholders, after the allocation of the bank's share as a *mudarib* to absorb losses attributed to investments financed by IAHs before the losses affect the equity of IAHs. Shareholders cannot contribute to this reserve because this is considered as indirectly compensating IAHs for losses, which is strictly prohibited by the *mudarabah* contract.
23. The mismatch of assets and liabilities of Islamic banks exposes these banks to rate of return risk.
24. See Archer and Karim (2006a).
25. Forcing Islamic banks by their regulators to smooth the IAH's profits from their *mudarib* share, in the absence of PER, may encourage the shareholders to contest such an action in courts. This is because when the shareholders bought their shares, the contractual relationship between the IAH and the bank, as specified in the *mudarabah* contract, did not specify such an obligation on the shareholders.
26. A related objective is to impede market discipline; see Section 4.
27. While clearly incorrect from a juristic point of view in *Shari'ah*, such a treatment (combined with the "income smoothing" described), is at least consistent with the tendency of Islamic banks in some countries to consider unrestricted IAHs as close substitutes for conventional deposits (see Archer and Karim 2004).
28. As indicated in Section 3 above, the behavior of unrestricted IAHs may be considered to provide a rationale for such an approach. See, however, our comments in Section 5.
29. This is a lease contract that ends up with the transfer of ownership of the leased asset from the lessor to the lessee.
30. See Sundararajan (2004) for more detailed discussion of risks in Islamic banking.
31. In effect, they hold a "call" option over the bank's assets that they will exercise, only if the value of those assets is greater than the amount of other claims on the assets that rank as senior to theirs.
32. According to Franks and colleagues (2003, 11), in the European countries which they surveyed, "If parent firms believe that either the intrinsic value of their asset management firms or the loss of their own reputations outweigh the cost of compensating investors, they will protect investors against loss."
33. The only exception seems to be the regulatory framework that was developed by the Bahrain Monetary Agency.
34. Accounts receivable that result from sale of assets on a deferred payment basis—for example, *murabahah* and *salam*—represent in the majority of Islamic banks the highest percentage of total assets. With the exception of Malaysia, in almost all other countries Islamic banks follow the *Shari'ah* ruling that does not

allow the sale of debt except for the same amount. Hence, an Islamic bank is unlike an asset management company, since if an asset management company collapses and the investor funds are held separately from the company's own assets, portfolios under management can be transferred at a low cost from that asset management company to another (Dale 1996; Franks and Mayer 1989).

REFERENCES

ABA Committee on Corporate Laws. 1990. "Other Constituencies' Statutes: Potential for Confusion." *Business Law* 45: 2253–2269.

Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). 1993. Financial Accounting Statement No. 2, Concepts of Financial Accounting for Islamic Banks and Financial Institutions. Manama, Bahrain: AAOIFI.

Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). 1996. Financial Accounting Standard No. 3, Mudaraba Financing. Manama, Bahrain: AAOIFI.

Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). 1997. Financial Accounting Standard No. 6, Equity of Investment Account Holders and Their Equivalent. Manama, Bahrain: AAOIFI.

Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). 1999a. Governance Standards for Islamic Financial Institutions No. 1, Shari'a Supervisory Board: Appointment, Composition and Report. Manama, Bahrain: AAOIFI.

Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). 1999b. Financial Accounting Standard No. 11, Provisions and Reserves. Manama, Bahrain: AAOIFI.

Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). 1999c. Statement on the Purpose and Calculation of the Capital Adequacy Ratio for Islamic Banks, March. Manama, Bahrain: AAOIFI.

Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). 2002a. Accounting, Auditing and Governance Standards for Islamic Financial Institutions. Manama, Bahrain: AAOIFI)

Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). 2002b. Shari'ah Standard No. 13, Mudaraba. Manama, Bahrain: AAOIFI.

Al-Deehani, T., R.A.A. Karim, and V. Murinde. 1999. "The Capital Structure of Islamic Banks under the Contractual Obligation of Profit Sharing." *International Journal of Theoretical and Applied Finance* 2 (3): 243–283.

Archer, S. and R.A.A. Karim. 2004. "Capital Adequacy for Institutions Offering Islamic Financial Services: Regulatory Rationales and Key Conceptual Issues." IFSB Working Paper, presented at the International Seminar on Comparative Banking Supervision, Beirut, December.

Archer, S. and R.A.A. Karim. 2006a. "On Capital Structure, Risk Sharing and Capital Adequacy in Islamic Banks." *International Journal of Theoretical and Applied Finance* 9 (3): 269–280.

Archer, S, and R.A.A. Karim. 2006b. "Corporate Governance, Market Discipline and Regulation of Islamic Banks." *The Company Lawyer* 27 (5): 134–145.

Archer, S. and R.A.A. Karim. 2009. "Profit Sharing Investment Accounts in Islamic Banks: Regulatory Problems and Possible Solutions." *Journal of Banking Regulation* 10: 300–306.

Archer, S. and R.A.A. Karim. 2012. "Structure, Regulation and Supervision of Islamic Banks." *Journal of Banking Regulation* (forthcoming).

Archer, S., R.A.A. Karim, and T. Al-Deehani. 1998. "Financial Contracting, Governance Structures and the Accounting Regulation of Islamic Banks: An Analysis in Terms of Agency Theory and Transaction Cost Economics." *Journal of Management and Governance* 2: 149–170.

Archer, S., R.A.A. Karim, and V. Sundararajan. 2010. "Supervisory, Regulatory and Capital Adequacy Implications of Profit-Sharing Investment Accounts in Islamic Finance." *Journal of Islamic Accounting and Business Research* 1 (1): 10–31.

Belkhir, M. 2012. "Do Subordinated Debt Holders Discipline Bank Risk-Taking? Evidence from Risk Management Decisions." *Journal of Financial Stability* (in press).

BCBS (Basel Committee on Banking Supervision). 2004, June. International Convergence of Capital Measurement and Capital Standards: A Revised Framework. Basel: Bank for International Settlements.

Baumann, U. and E. Nier. 2003. "Market Discipline and Financial Stability: Some Empirical Evidence." *Financial Stability Review* (June): 134–141.

Blum, J. 2002. "Subordinated Debt, Market Discipline, and Banks' Risk Taking." *Journal of Banking and Finance* 26 (7): 1427–1441.

Bryer, R. A. 1993. "Double-Entry Bookkeeping and the Birth of Capitalism: Accounting for the Commercial Revolution in Medieval Northern Italy." *Critical Perspectives on Accounting* 4 (2): 113–140.

Caprio, G. Jr. and R. Levine. 2002. "Corporate Governance of Banks: Concepts and International Observations." Paper presented at the Conference on Building the Pillars of Financial Sector Governance: The Roles of Public and Private Sectors, organised by the World Bank, IMF, and Brookings Institution.

Charkham, J. 2003. Guidance for the Directors of Banks, Global Corporate Governance Forum, Focus 2, The World Bank.

Çizakça, M. 1996. *A Comparative Evolution of Business Partnerships: The Islamic World & Europe, with Specific Reference to the Ottoman Archives*. Leiden, The Netherlands: E. J. Brill.

Cordella, T. and E. L. Yeyati. 1998. "Public Disclosure and Bank Failures." CEPR Discussion Paper No. 1886.

Crockett, A. 2001. "Market Discipline and Financial Stability." Paper presented at the Banks and Systemic Risk Conference, Bank of England, London, 22–25 May, 1–9. www.bis.org/speeches/sp010523.htm.

Dale, R. 1996. *Risk and Regulation in Global Securities Markets*. Chichester, West Sussex: John Wiley & Sons Ltd.

Dann, L. and H. DeAngelo. 1985. "Corporate Financial Policy and Corporate Control: A Study of Defensive Adjustments in Asset and Ownership Structure." *Journal of Financial Economics* 15: 87–127.

Dermine, J. 2011. "Bank Corporate Governance, Beyond the Global Banking Crises." INSEAD Faculty & Research Working Paper.

Evanoff, D.D. and L.D. Wall. 2000. "Subordinated Debt as Bank Capital: A Proposal for Regulatory Reform." Economic Perspectives, Federal Reserve Bank of Chicago.

Franks, J. and C. Mayer. 1989. *Risk, Regulation and Investor Protection: The Case of Investment Management*. Oxford: Oxford University Press.

Franks, J., C. Mayer, and L. Correia da Silva. 2003. *Asset Management and Investor Protection: An International Analysis*. Oxford: Oxford University Press.

Hamalainen, P. 2004. "Mandatory Subordinated Debt and the Corporate Governance of Banks." *Corporate Governance: An International Review* 12 (1): 93–106.

Islamic Financial Services Board (IFSB). 2005. *Guiding Principles of Risk Management for Institutions (Excluding Islamic Insurance (Takaful) Institutions and Collective Investment Schemes)*. Kuala Lumpur, Malaysia: IFSB.

Islamic Financial Services Board (IFSB). 2009. *Guidance on Disclosures to Promote Transparency and Market Discipline*. Kuala Lumpur, Malaysia: IFSB).

Karim, R.A.A. 1996. "The Impact of the Basle Capital Adequacy Ratio Regulation on the Financial and Marketing Strategies of Islamic Banks." *The International Journal of Bank Marketing U.K.* 14 (7): 32–44.

Karim, R.A.A. 2001. "International Accounting Harmonisation, Banking Regulation and Islamic Banks." *The International Journal of Accounting* 36 (2): 169–193.

Karim, R.A.A. 2011. "Challenges of Regulation and Supervision of Islamic Banks." Islamic Development Bank's Prize Lecture, August.

Kirkpatrick, G. 2009. "The Corporate Governance Lessons from the Financial Crisis." Organisation for Economic Co-operation and Development (OECD). www.oecd.org/corporate/corporateaffairs/corporategovernanceprinciples/42229620.pdf

Levine, R. 2003. "The Corporate Governance of Banks: A Concise Discussion of Concepts and Evidence." Discussion Paper No. 3, paper presented at the Global Corporate Governance Forum, Paris, October.

Llewellyn, D. 1999. "The Economic Rationale for Financial Regulation." FSA Occasional Paper Series 1, Financial Services Authority, London.

Macy, J. R. and M. O'Hara. 2003. "The Corporate Governance of Banks." *FRBNY Economic Policy Review* (April): 91–107.

Mallat, C. 1988. "The Debate on Riba and Interest in Twentieth Century Jurisprudence." *Islamic Law and Finance*, edited by C. Mallat, 69–88. London: Graham & Trotman.

Mustafa, B. G. 2003. "The Implementation of Accounting Standards for Islamic Banks: A Study of Preparers' and Auditors' Opinions in Sudan." Unpublished PhD thesis, University of Surrey, U.K.

Organisation for Economic Co-operation and Development (OECD). 2009. "Corporate Governance and the Financial Crises." www.oecd.org/corporate/corporateaffairs/corporategovernanceprinciples/43056196.pdf.

Peni, E. and S. Vähämaa. 2011. "Did Good Corporate Governance Improve Bank Performance During the Financial Crises." *Journal of Financial Services Research*, March.

Rodriguez, L. J. 2002. "International Banking Regulation: Where's the Market Discipline in Basel II?" *Policy Analysis* 455 (October 15): 1–27.

Saleh, N. A. 1992. *Unlawful Gain and Legitimate Profit in Islamic Law*. London: Graham & Trotman Ltd.

Scott, J. 1997. *Corporate Business and Capitalist Classes*. Oxford: Oxford University Press.

Shleifer, A. and R. W. Vishny. 1997. "A Survey of Corporate Governance." *The Journal of Finance* 52 (2): 737–783.

Sijben, J. J. 2002. "Regulation versus Market Discipline in Banking Supervision: An Overview—Part 2." *Journal of International Banking Regulation* 4 (1): 55–71.

Sundararajan, V. 2004. "Risks in Islamic Banking and the General Framework to Deal with these Risks." Paper presented at the Symposium on Risk Management in Islamic Banking Services, Institute of Banking, Riyadh, Saudi Arabia, 24–25 February.

Taylor, T. W., and J. W. Evans. 1987. "Islamic Banking and the Prohibition of Usury in Western Economic Thought." *National Westminster Bank Quarterly Review* (November): 15–27.

Udovitch, A.L. 1970. *Partnership and Profit in Medieval Islam*. Princeton, NJ: Princeton University Press.

Vogel, F.E., and S.L. Hayes. 1998. *Islamic Law and Finance: Religion, Risk and Return*. The Hague: Kluwer Law International.

Williamson, O.E. 1996. *The Mechanisms of Governance*. Oxford: Oxford University Press.

World Bank. 2001. *Finance for Growth: Policy Choices in a Volatile World*. New York: Oxford University Press.

CHAPTER 22

Transparency and Market Discipline: Post–Basel Pillar 3

Daud Abdullah (David Vicary)

1. INTRODUCTION

In the wake of the financial crisis that started in 2007, there have been significant developments in the global financial services industry. In particular, the world economies were hit by a major global financial crisis, by most accounts the worst since the Great Depression, which was triggered by the subprime crisis in the United States. According to the Federal Deposit Insurance Corporation (FDIC), the regulator for the banking industry in the United States, prior to the financial crisis, from 2000 to 2007, a total of 27 banks had failed. Since then, however, a further 412 banks had folded between 2008 and November 2011—a staggering 15-fold increase! The root causes of these failures have been well documented by *The Financial Crisis Inquiry Report*[1] released in January 2011, which, while beyond the scope of the present chapter, is essential reading in order to be able to see the fuller picture.

How did the Islamic financial services industry perform during the financial crisis? Recent studies seem to suggest that, under specific conditions, Islamic banks performed better than their conventional counterparts during and post–financial crisis.[2] To date, at least three Islamic banks across the globe have failed. Ihlas Finans House of Turkey was shut down in 2001 due to issues relating to liquidity; Albaraka International Bank in the United Kingdom was closed in 1993 in the aftermath of the Bank of Credit and Commerce International (BBCI) and ING Baring banking collapses (as well as for other regulatory reasons); and Bank Al Taqwa was shut down in 2001

Islamic Finance: The New Regulatory Challenge.
Edited by Simon Archer and Rifaat Ahmed Abdel Karim
Copyright © 2013 by John Wiley & Sons Singapore Pte. Ltd.
ISBN: 978-1-118-62897-3

by the Bahamas authorities, also for regulatory reasons. The closures of all of these banks were independent of the recent financial crisis.

In the wake of the crisis, financial regulators and authorities across the globe have struggled either to tighten existing laws or to enact new ones governing financial institutions, with some taking remedial action more quickly than others. All of these efforts were made with the objectives of enhancing transparency and promoting greater market discipline towards providing a sound and stable financial services industry. The markets need certainty, and the consumers need to feel confident about the markets.

The author is of the opinion that good standards of transparency and market discipline are closely interlinked with good standards of corporate governance. As most of you will be aware, there are many areas of similarity, with regard to corporate governance, between conventional and Islamic financial institutions. You will also be aware that there are some specific corporate governance issues that pertain only to Islamic banks. I do not intend to revisit the subject of corporate governance in any great detail during this chapter, merely to stress the importance of building a firm base of governance in order to help achieve good levels of transparency and market discipline.

It would be as well, in the context of this chapter, to give some insight as to the guiding principles of market discipline applicable to financial institutions in general. Probably there is no better source than members of the Basel Committee themselves, who opine, with respect to conventional banking, that:

> *The purpose of Pillar 3—Market discipline is to complement the minimum capital requirements (Pillar 1) and the supervisory review process (Pillar 2). The Committee aims to encourage market discipline by developing a set of disclosure requirements which will allow market participants to assess key pieces of information on the scope of application, capital, risk exposures, risk assessment processes, and hence the capital adequacy of the institution. The Committee believes that such exposures have particular relevance under the Framework, where reliance on internal methodologies gives banks more discretion in assessing capital requirements.*
>
> *In principle, banks' disclosures should be consistent with how senior management and the board of directors assesses and manages the risks of the bank. Under Pillar 1, banks use specified approaches/methodologies for measuring the various risks they face and the resulting capital requirements. The Committee believes that providing disclosures that are based on this common framework is an effective means of informing the market about a bank's exposure*

> *to those risks and provides a consistent and understandable disclosure framework that enhances comparability.*[3]

In a nutshell, then, the purpose of Pillar 3 is to focus on two key areas: first, to reinforce market discipline through enhanced disclosure, which includes the capital adequacy calculations; and second, to instil market discipline to reinforce minimum capital requirements, to impose incentives for banks to behave prudently, and to promote safety and soundness in banks and financial systems. These principles have been reiterated for application to Islamic banks by the Islamic Financial Services Board's *Guidance on Disclosures to Promote Transparency and Market Discipline for Institutions Offering Islamic Financial Services* (December 2007)—see Section 3. Under no circumstances should Pillar 3 be seen as a way to get the market to do the supervisor's job or, indeed, to get the market to police the supervisors. Let me leave that thought with you there, and I shall return to it later in this chapter.

Section 1 has provided a quick introduction, briefly covering the principles underlying transparency and market discipline as documented in Pillar 3. The rest of this chapter proceeds as follows: Section 2 discusses the compliance status of Pillar 3; Section 3 has been expanded with the inclusion of the role of the Islamic Financial Services Board (IFSB) in view of the significant contributions it has made towards the achievement of a sound and stable Islamic financial services industry; Section 4 provides the conclusion.

2. COMPLIANCE WITH PILLAR 3

What, then, is required of banks to comply with the requirements of Pillar 3? The requirements may be summarised under the following headings in this section:

- Level of Disclosure
- Frequency of Disclosure
- Disclosure Templates
- Basic Principle of Disclosure

2.1 Level of Disclosure

With regard to the level of disclosure, it is mandatory for all banks to disclose at the standard or basic level. Additional mandatory disclosures will be required for those banks taking advanced approaches.

2.2 Frequency of Disclosure

Disclosure should be made every six months via sources that are set by the respective national supervisors. Qualitative disclosures should be made annually. In situations where information on risk exposure is prone to rapid change, disclosure should be made on a quarterly basis. All information provided is subject to verification.

2.3 Disclosure Templates

Templates have been suggested as a means to ensure comparability between banks.

2.4 Basic Principle of Disclosure

Disclosure should be consistent with how senior management and the board of directors assess and manage risks.

Thirteen tables are prescribed in Pillar 3 relating to market discipline and the respective aspects of qualitative and quantitative exposures for each table:

1. Scope of application: Gives details on the qualitative and quantitative disclosures required. This allows the market to assess how Basel II applies to a banking group and how the various entities within the group are treated for capital adequacy purposes.
2. Capital structure: Summary information on the terms and conditions of the main features of all capital instruments. Disclosure about the amount, components, and features of capital provides market participants with important information about a bank's ability to absorb financial losses. Information on the terms and conditions of capital instruments provides additional background on the loss-absorbing capacity of capital instruments and provides a context for the analysis of the capital adequacy of the bank.
3. Capital adequacy: A summary discussion of the bank's approach to assessing the adequacy of its capital to support current and future activities. Capital requirements for credit risk, equity exposures in the internal ratings-based (IRB) approach, market risk, operational risk, and the total and Tier 1 capital ratio. To provide market participants with a link between the disclosure of capital and risk exposure and assessment, it is important that a bank publishes information about its capital adequacy based on Basel II. Under Pillar 2 it is recommended that all banks have an internal process for assessing their capital

adequacy and for setting appropriate levels of capital. This process should be objective and overseen by senior management, and all banks should be able to demonstrate that the results of their internal processes are credible and reliable. Information provided about a bank's capital allocation process assists market participants in gaining a better understanding of the risks and rewards inherent in the bank's activities.

4. Credit risk: General disclosures for all banks from both a qualitative and quantitative perspective. This section sets out general credit risk exposures for all banks, regardless of which regulatory capital assessment technique they use. The aim is to give an overview of the size and nature of the bank's credit risk exposure and to provide the context for information on how a bank assesses and manages that risk.
5. Credit risk: Disclosures for portfolios subject to the standardised approach and supervisory risk weights in the IRB approaches. This allows the market to assess asset quality by providing a breakdown of the bank's exposures in the standardised framework. Furthermore, this provides market participants with a sense of the suitability of the standardised approach for the particular institution (that is, that the resulting weights for capital purposes properly reflect the exposure of the underlying asset) and provides a basis for comparative analysis of banks.
6. Credit risk: Disclosures for portfolios subject to IRB approaches. This disclosure regime is intended to enable market participants to assess the credit risk exposure of IRB banks and the overall application and suitability of the IRB framework, without revealing proprietary information or duplicating the role of the supervisor in validating the detail of the IRB framework in place.
7. Credit risk mitigation: Disclosures for standardised and IRB approaches. Basel II recognises an enlarged range of credit risk mitigation techniques for regulatory capital purposes. The disclosure regime is intended to allow market participants to assess the types of mitigation employed and their impact on risk and regulatory capital levels.
8. Securitisation: Disclosure for standardised and IRB approaches. In order to gain preferential capital treatment with respect to asset securitisation, a bank must disclose information about the size, type, and features of securitisations to allow market participants to assess the resulting impact on the bank's risk profile.
9. Market risk: Disclosures for banks using the standardised approach. The disclosure regime for the standardised approach is based on the capital charge as a proxy for the risk indicator, allowing a comparison between different types of risks and between different institutions.

10. Market risk: Disclosures for banks using the internal models approach (IMA) for trading portfolios. The disclosure regime for the IMA is based on the value-at-risk (VaR) concept, the common metric in internal market risk models. Market participants can judge the exposure to market risk and verify the results of the model, in broad terms, compared to the actual outcomes. The qualitative disclosure of portfolios covered by the IMA allows market participants to evaluate the sophistication of the bank's risk measurement and management based on the qualifying criteria for the IMA.
11. Operational risk: This is an important feature of Basel II. The metric to assess exposure, across all capital calculation types, is the capital charge itself. The disclosure of the regulatory capital approach that a bank qualifies for—basic indicator, standardised, or advanced measurement approach—provides useful information to market participants about the quality of risk identification, measurement, monitoring, and control as incremental standards apply to each of the three capital assessment techniques.
12. Equities: Disclosures for banking book positions. Note that for Islamic banks, equity positions in the banking book include assets resulting from financings made by the bank based on *musharakah* or *mudarabah* contracts.
13. Interest rate risk in the banking book (IRRBB): Interest rate risk in the banking book does not attract a minimum regulatory capital charge in Pillar 1, but is rather dealt with under Pillar 2—the supervisory review process. This places considerable importance on the disclosure of comparable information by banks to allow market participants to assess the current and potential level of interest rate risk in the banking book, the means by which the bank identifies, measures, monitors, and controls the risk, and the results of this process. For Islamic banks, there is no IRRBB as such, but there is rate of return risk which is a major factor in displaced commercial risk. Rate of return risk, insofar as it contributes to displaced commercial risk, is therefore dealt with under the Islamic Financial Services Board's (IFSB's) Capital Adequacy Standard (Pillar 1).

In addition to the above, the Basel Committee's more recent pronouncements place some emphasis on *liquidity risk*. The International Accounting Standards Board's IFRS 7, *Financial Instruments: Disclosure* also sets out some disclosure requirements regarding liquidity risk, as does the IFSB's *Guidance on Disclosures to Promote Transparency and Market Discipline for Institutions Offering Islamic Financial Services*.

While there may be a need to change some of the details in Pillar 3 to adapt to the requirements of Islamic banks, the general direction and relevance of these essential elements of market discipline cannot be denied. They will therefore be generally applicable to the world of Islamic finance. However, like everything else, there are potential benefits and drawbacks to their implementation. In particular, I would draw your attention to the need for a sense of balance between the regulators and the market. Section 3 discusses the *Guidance* (or Standard) issued by the IFSB pertaining to transparency and market discipline for Institutions Offering Islamic Financial Services (IIFS).

3. TRANSPARENCY AND MARKET DISCIPLINE: SPECIFICITIES OF ISLAMIC FINANCE

This chapter focuses on transparency and market discipline, in tandem with Basel Pillar 3. In particular, this chapter relies heavily on *IFSB-4: Disclosures to Promote Transparency and Market Discipline for Institutions Offering Islamic Financial Services (Excluding Islamic Insurance (Takaful) Institutions and Islamic Mutual Funds)*.[4]

The Standard is designed to specify principles to be followed by IIFS as well as the regulatory agencies in achieving transparency and promoting market discipline. The IFSB Standard has been developed for various types of stakeholders of the IIFS and complemented by the observance of the international standards and best practices. Exhibit 22.1, for example, summarises the similarities between the Basel Pillar 3 Transparency and Market Discipline and that of the IFSB's Standard.

The essence of the Standard is the importance of disclosure in promoting market discipline, as well as providing investor protection and creating investor confidence. Thus, to achieve this mandate, the Standard is applicable to both the IIFS and the Islamic window operations offered by conventional banks involved in managing funds in the form of restricted investment accounts. The Standard draws upon the specific features of the IIFS that are absent or not captured in the existing guidelines and principles relating to bank transparency and bank governance issued by the Basel Committee on Banking Supervision, and disclosure standards (Pillar 3) contained in the new Basel Capital Accord. The Standard also builds on the standards for Collective Investment Schemes (CIS) and on international accounting and auditing standards.

One of the challenges of implementing this Standard is the nonbinding nature of all the IFSB's Standards, Technical Notes, and Guidance Notes in

EXHIBIT 22.1 The IFSB and Basel Pillar III Standards

Prudential and Regulatory Areas	IFSB Standards	Basel Committee on Banking Supervision Standards	Remarks
Transparency and Market Discipline	Yes	Yes	Both the IFSB and BCBS standards are aimed at enhancing market participants' access to relevant, reliable, and timely information on the financial institutions. The IFSB-4 has recommended additional disclosures with respect to IIFS' management of profit-sharing investment accounts (PSIA), given the distinct contractual relationship established between the IIFS and the Islamic bank account holders under the *mudarabah* contract.

Source: IFSB, IDB, and IRTI. 2010. Islamic Finance and Global Financial Stability, 60.

various jurisdictions. (The same applies, in principle, to the pronouncements of the Basel Committee and other international standard-setting bodies that rely on national regulators for enforcement.) Thus, the effectiveness of the implementation of these Standards may vary from country to country. However, this particular Standard is not in conflict with the existing international accounting standards and other relevant national standards.

The objectives of the Standard are:[5]

- To enable market participants to complement and support, through their actions in the market, the implementation of the Islamic Financial Services Board's capital adequacy, risk management, supervisory, and corporate governance standards; and
- To facilitate access to relevant, reliable, and timely information by market participants generally, and by investment account holders (IAH) in particular, thereby enhancing their monitoring capacity.

To achieve transparency and market discipline, the financial market needs a well-functioning infrastructure, as illustrated in Exhibit 22.2.

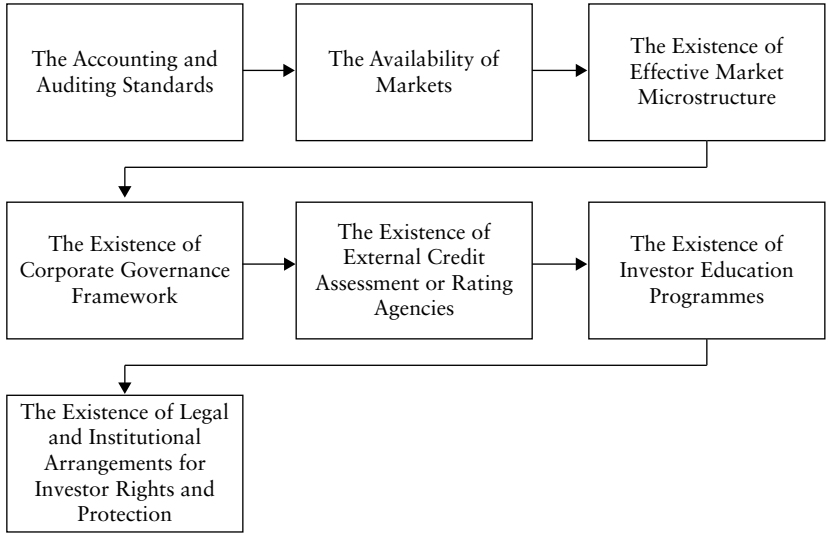

The Accounting and Auditing Standards
The Availability of Markets
The Existence of Effective Market Microstructure
The Existence of Corporate Governance Framework
The Existence of External Credit Assessment or Rating Agencies
The Existence of Investor Education Programmes
The Existence of Legal and Institutional Arrangements for Investor Rights and Protection

EXHIBIT 22.2 The Infrastructure for an Effective Transparency and Disclosure Regime for IIFS[6]

3.1 The Islamic Financial Services Board's Disclosures in Achieving Transparency and Creating Market Discipline

The IFSB Standard on Transparency and Market Discipline can be divided into five broad categories, and for each of these categories there could be Qualitative and/or Quantitative Disclosures. The categories are:

Financial and Risk Disclosure Principles IIFS must establish internal disclosure policies with regard to the nature of disclosures it will make and the internal controls over the disclosure process. This process must identify the appropriateness and the frequency of the disclosures. The Standard provides guidelines on "comply and explain" basis on the following items:

a. *Corporate information*. An IIFS must provide the summary of the corporate information, indicating whether it is a stand-alone IIFS or an Islamic window, and the bases of consolidation for financial reporting and for regulatory purposes.
b. *Capital structure, including equity of unrestricted IAH*. The Standard recommends for the IIFS to disclose total and Tier 1 capital by the top consolidated entity, equity of unrestricted IAH, and the related

prudential reserves of the IAH. Items recommended to be disclosed include: the amount of Tier 1 capital, the total amount of Tier 2 and Tier 3 capital, total eligible capital, the amount of unrestricted IAH funds, and profit equalisation reserve (PER) and investment risk reserve (IRR).

c. *Capital Adequacy*. It is very important to note that there exist clear distinctions between the IIFS and conventional banks in determining the capital adequacy requirements:
   i. The financing arrangements, under the IIFS, are either asset based or profit- and loss-sharing (*musharakah*) contract, or profit-sharing or loss-bearing (*mudarabah*) contract.
   ii. The funding for the IIFS that is raised through unrestricted investment accounts is in a form of equity. Thus, the underlying assets involved under the *Shari'ah*-compliant financing contracts may be exposed to market (price) risk, as well as to credit risk in respect of the amount due from the counterparty.

Disclosures for IAH An IIFS obtains funds from the IAH under the profit-sharing and loss-bearing *mudarabah* contract. It is recommended for the IIFS to disclose specific policies, procedures, product design/type, profit allocation basis, and differences between restricted and unrestricted IAH.

The profit-sharing investment accounts (PSIA) are very similar to the collective investment schemes (CIS), thus the available international standards, guidelines and discussions on risk disclosures by the CIS, and on the role of investor education in the effective regulation of the CIS and CIS operators, can be replicated in designing policies for the IIFS.

The disclosures are recommended by the IFSB Standard to be made as part of the *periodic external financial reporting process* (marked "F") or as part of *product information published in connection with new products or changes in existing products* (marked "P"). The disclosures can be classified by the following:

a. Disclosures applicable to investment accounts (both unrestricted and restricted IAH).
b. Disclosures specific to unrestricted investment accounts.
c. Disclosures specific to restricted investment accounts.

Retail Investor-Oriented Disclosures for IAH The IIFS is recommended to publish a simplified and uncomplicated financial/annual report for the retail investors. While some of these disclosures might require great detail, they must be presented in nontechnical language. Items proposed by the Standard

to be included in the risk-return characteristics of products, such as the restricted and unrestricted PSIA, are:

- **a.** For the unrestricted PSIA, the extent to which the IIFS is committed by its policies to maintaining the IAH's investors' capital intact and to paying a competitive rate of return by accepting displaced commercial risk (DCR).
- **b.** The management fees as a percentage of the total investment profit.
- **c.** IAH's right to withdraw funds during the term of the *mudarabah* contract.
- **d.** The extent of management's right to appropriate the IAH's share of investment profits in order to build up PER and/or IRR.
- **e.** Investment and asset allocation policies for IAH funds.
- **f.** For the unrestricted IAH, the extent of any sharing of profits from the IIFS' provision of fee-based banking.
- **g.** The availability of personal banking and investment advisory and financial planning services for the benefit of the IAHs.
- **h.** Complaints procedures available to dissatisfied IAHs.

Risk Management, Risk Exposures, and Risk Mitigation The purpose of this disclosure is to ascertain the nature of risk to which the IIFS is exposed and the techniques it uses to identify, measure, monitor, and control those risks.

The Standard provides several key financing risks as well as specific risks faced by the IIFS. It is recommended that for each area of risk, the IIFS describes: the risk management objectives, policies, and practices; the structure and organisation of the relevant risk reporting and measurement systems; the measures and indicators of risk exposures; policies for hedging and/or mitigating risk; strategies and processes for monitoring the continuing effectiveness of risk management tools; and techniques such as hedging and other risk mitigants.[7]

- **a.** *Credit risk*. This refers to the exposure to the likelihood that the counterparty will fail to meet its obligations in accordance with agreed terms. This definition is applicable to the IIFS both in terms of managing the financing exposures of receivables such as *murabahah*, diminishing *musharakah*, and *ijarah* contracts, as well as to working capital financing such as *salam*, *istisna'a*, or *mudarabah* contracts. It also includes non-traded equity instruments such as *mudarabah* and *musharakah* contracts.
- **b.** *Credit risk mitigation*. The IIFS is recommended to make disclosures on credit risk mitigation. These include, among others, the disclosure on the nature of the collateral used and other *Shari'ah*-compliant risk mitigation techniques.

c. *Liquidity risk*. This refers to the potential loss to the IIFS arising from its inability either to meet its obligations or to fund increases in assets as they fall due without incurring unacceptable costs or losses.[8] The IIFS must provide a summary of liquidity risk management framework for current account, unrestricted investment accounts, and restricted investment accounts.
d. *Market risk*. This refers to the risk of losses in both on-balance sheet and off-balance sheet positions arising from movements in market prices—for instance, fluctuations in values in tradable and marketable instruments (including *sukuk*), in investments in lease assets, and in off-balance sheet individual portfolios (such as restricted investment accounts). The risk arises from the current and future volatility of market values of specific assets and of foreign exchange rates.[9]
e. *Operational risk*. This refers to the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events, including losses resulting from *Shari'ah*–non-compliance and the failure in fiduciary responsibilities of the IIFS towards different fund providers. Failure of these controls may affect the soundness of the IIFS's operations and its reliability of reporting.[10]
f. *Rate of return risk*. This refers to the possible impact on the net income of the IIFS arising from the impact of changes in the market rates and relevant benchmark rates on the return on assets and on the returns payable on funding.[11]
g. *Displaced commercial risk*. It refers to the magnitude of risks that are transferred to shareholders in order to cushion the IAH from bearing some or all of the risks. The risks arising from assets managed on behalf of the IAH are effectively transferred to the IIFS's own capital because the IIFS follows the practice of foregoing part or all of its share of profit as the *mudarib*[12] on such funds, when it considers this necessary as a result of commercial pressure in order to increase the return that would otherwise be payable to the IAH.[13]
h. *Contract-specific risk*. Each type of Islamic financing asset is exposed to a varying mix of credit and market risks. Thus, the IIFS is recommended to disclose its policy on relative shares of various *Shari'ah*-compliant financing contracts and capital allocation for various types of *Shari'ah*-compliant financing contracts. The IIFS is to disclose total risk weighted assets (RWA) classified by type of *Shari'ah*-compliant financing contract.[14]

General Governance and *Shari'ah* Governance Disclosures Other than for the purpose of establishing general and *Shari'ah* governance processes, structure, and function of such governance in an IIFS, the primary objective of the disclosures is to ensure transparency regarding the status of *Shari'ah* compliance.

a. *General governance disclosure*. The IIFS is recommended to disclose and explain any departure from complying with the applicable financial reporting standards; whether the IIFS complies in full with the IFSB's *Corporate Governance Standard*, and to provide explanation on noncompliance; disclosure on consumer/investor education; and disclosure of social functions and charitable contributions of the IIFS, such as *sadaqah*, *qard*, and so forth.
b. *Shari'ah governance disclosure*. Primarily, the IIFS is recommended to provide a statement on the governance arrangement, systems and control mechanisms to ensure *Shari'ah* compliance and in accordance to the established national and international standards; disclosure of how *Shari'ah* noncompliant earnings and expenditure occur and the manner in which they are disposed of; disclosure on whether compliance with *Shari'ah* rulings is mandatory or not; disclosure of the nature, size, and number of violations of *Shari'ah* compliance during the year; disclosure of annual *zakat* contributions of the IIFS; and remuneration of the *Shari'ah* board members.

In strengthening the IIFS in the wake of the recent global financial crises, the IFSB and the Islamic Development Bank (IDB) published a joint report entitled *Islamic Finance and Global Financial Stability* in April 2010. The report identified the following eight building blocks to strengthen the infrastructure and framework of the Islamic financial services industry.[15]

1. The development of a set of comprehensive, cross-sectorial prudential standards and supervisory framework covering Islamic banking, *takaful* and the capital market, which takes into account the specificities of the IIFS.
2. The development of a liquidity management infrastructure.
3. Strengthening of the financial safety net mechanism—lender of last resort (LOLR) facilities and emergency financing mechanisms, as well as deposit insurance that is compatible with the *Shari'ah* principles.
4. The development of a reliable crisis management and resolution framework—which includes bank insolvency laws and the arrangements for dealing with nonperforming assets, asset recovery and bank restructuring, and recapitalisation.
5. The establishment of accounting, auditing, and disclosure standards for IIFS and their counterparties, supported by adequate governance arrangements.
6. The development of the macroprudential surveillance framework and financial stability analysis as an integral part of the strategy to strengthen the resilience of the Islamic financial system and to minimise the risks of financial fragility.

7. Strengthening rating processes for Islamic institutions or instruments by reexamining and improving the related core processes to encourage greater transparency on the risk involved.
8. Capacity building and talent development—the international Islamic supranational and developmental bodies need to consider more involvement in capacity building to promote global financial stability.

"Market discipline" refers to the use of the market as a means of governance, as a complement to regulation and supervision. The potential benefits and drawbacks of this approach are set out in Exhibit 22.3.

I would also like to reiterate some thoughts developed by Andrew Crocket, former Bank for International Settlements general manager, on the conditions necessary for effective market discipline (see Exhibit 22.4). These thoughts are equally applicable to the world of Islamic banking, which is in the context of market discipline, very similar to conventional practices. First, *information*: market participants must have sufficient information to reach informed judgments. Second, *ability*: market participants must have the ability to process information correctly. Third, *incentive*: market participants must have the right incentive to act upon information. Fourth,

EXHIBIT 22.3 Potential Benefits and Drawbacks of Market Discipline in Islamic Banking

Potential Benefits	Potential Drawbacks
■ It can provide Islamic financial institutions with the necessary incentive to properly address relevant corporate governance issues and behave responsibly. ■ Market reactions to early signs of distress in individual institutions provide impetus for the institution to rectify problems, hence preventing possible bank failures. ■ Lower risk premiums in the marketplace resulting from transparency of operations, which is a prerequisite for effective market discipline. ■ Potential time and cost savings for regulators.	■ There may be a conflict of interest between regulators and the market (issue of public versus private interest). For example, markets may react too strongly on institutions in a weakened position, resulting in unnecessary failures, which regulators would prefer to avoid in order to maintain the soundness and stability of the financial sector. ■ Loss of confidence in one bank may cause a "contagion" effect resulting in a systemic event occurring in the banking sector.

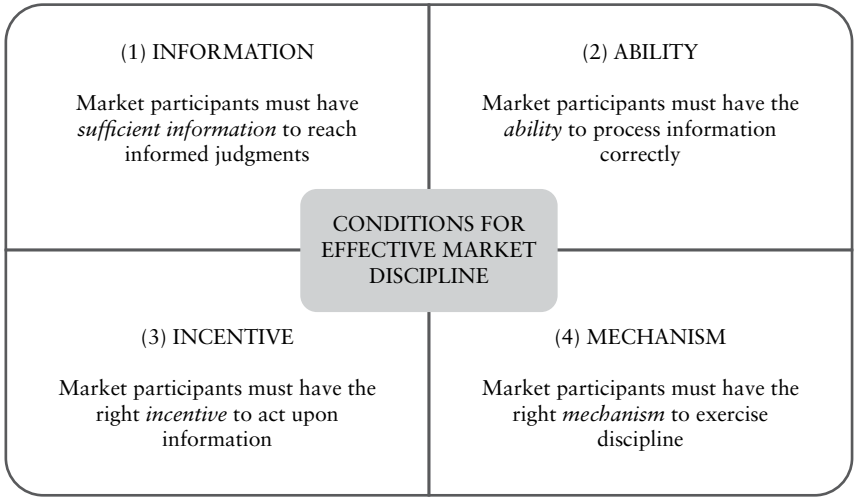

(1) INFORMATION
Market participants must have *sufficient information* to reach informed judgments
(2) ABILITY
Market participants must have the *ability* to process information correctly
CONDITIONS FOR EFFECTIVE MARKET DISCIPLINE
(3) INCENTIVE
Market participants must have the right *incentive* to act upon information
(4) MECHANISM
Market participants must have the right *mechanism* to exercise discipline

EXHIBIT 22.4 Developing Market Discipline in Islamic Finance

mechanism: market participants must have the right mechanism to exercise discipline. All four prerequisites will need to be developed in order to achieve effectiveness. However, the focus at this point in time should be on the first two conditions, without which we cannot move on to satisfy conditions three and four. Let me elaborate a little on the first two conditions.

1. Market participants need to have sufficient *information* to reach informed judgments:
   a. There is a pressing need to develop the informational infrastructure of the industry in order to promote transparency to enhance the understanding of the operations of Islamic financial institutions.
   b. Transparency facilitates decision making and hence improves the allocation of resources, as it enables us to better understand the intrinsic value of a financial institution.
2. Market participants need to possess the *ability* to process the information correctly:
   a. There is a need to grow the Islamic finance industry, as critical mass is necessary to attract capable market participants, such as analysts, brokers, ratings agencies, and institutional investors, with the ability to process correctly the information provided by the Islamic financial institutions. At this point in time, very few Islamic banks are rated. It is to be hoped that as the market gains critical mass, the value of obtaining an independent rating will also grow.

b. Thus it may, therefore, be easier to develop market discipline in countries with significant Islamic banking market penetration. The global share of *Shari'ah* compliant assets is as follows: Iran (35.71 percent), Saudi Arabia (13.89 percent), Kuwait (7.33 percent), Qatar (4.82 percent), Malaysia (12.28 percent), Bahrain (6 percent), and the United Arab Emirates (8.66 percent). About 40 percent of the total *Shari'ah* compliant assets reside in the GCC countries.[16]

Earlier in this chapter I indicated that I would return to discuss further the purpose of Pillar 3. You will recall that I highlighted that the purpose was *not* to get the market to do the supervisors' job and *not* to get the market to police the supervisors. At this juncture I should like to introduce the concept of a "virtuous cycle of transparency." This is a cycle that embraces all aspects of regulation, disclosure, transparency, corporate governance, market discipline, and the growth of the Islamic banking industry. Exhibit 22.5 illustrates the cycle.

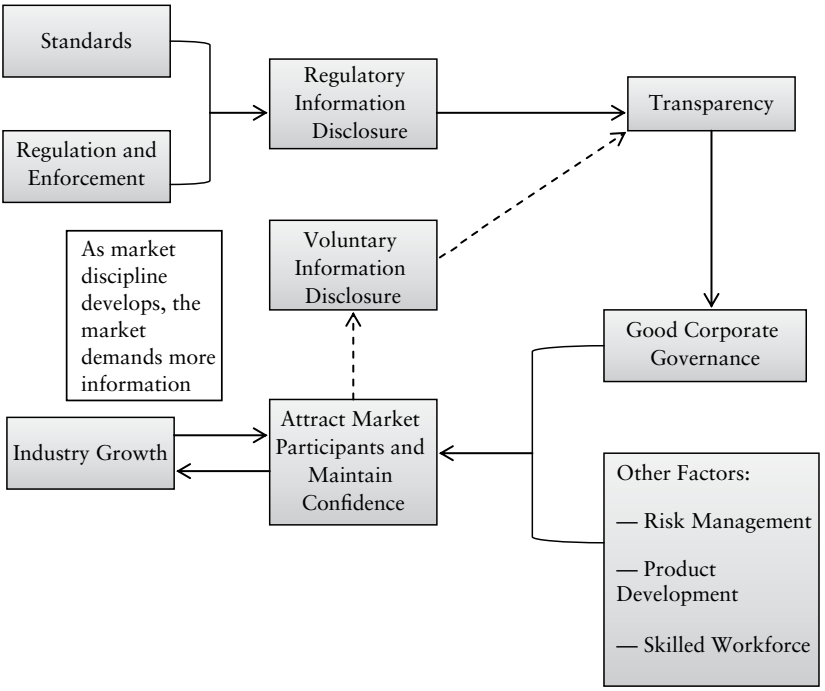


EXHIBIT 22.5 Transparency: A Virtuous Cycle

Let me first examine the role of regulators in this context (see Exhibit 22.6). Initially, standards need to be set. Here we already have Pillar 3 developed by the IFSB. The standards will need to be adopted by the local regulators on a country-by-country basis (central bank or equivalent). In this role of *standard setting*, the regulator(s) set the wheels of market discipline in motion by developing coherent regulatory disclosure requirements which the markets should find useful, both on a national and international basis. *Enforcement* would most likely come at the country level, whereby the central bank would enforce regulations by monitoring the implementation and compliance of Islamic financial institutions to the disclosure requirements. The regulator also needs to demonstrate *vigilance*; in particular, there is a need to be vigilant about negative signals sent by the market, as this may be an early warning of distress in individual institutions. Timely involvement by regulators may help to prevent or minimise the occurrence of bank failures.

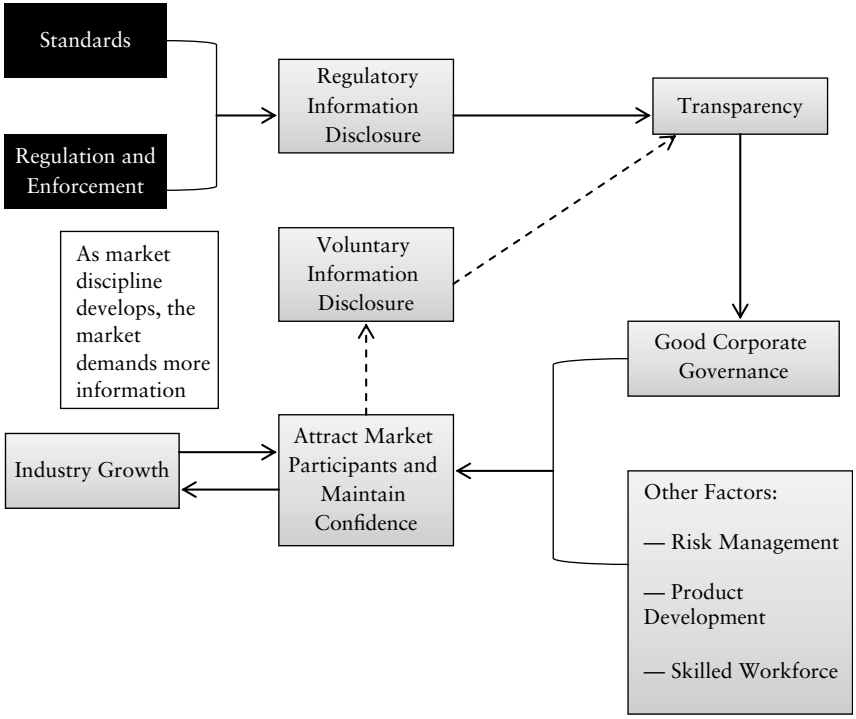


EXHIBIT 22.6 The Role of Regulators

Let me now examine what constitutes good information disclosure and lends itself to enhancing transparency in the marketplace. The board of directors and senior management of Islamic financial institutions must be committed to providing good information disclosure, both quantitative and qualitative, which meets the criteria of *useful, accurate, complete*, and *credible*.

Under the category *useful*, the information required depends on what the market discipline is aiming to achieve. For example, if the objective were to demonstrate to the market that the bank is performing satisfactorily with adequate profitability, then financial statements and comparative analysis would be useful information. If the objective is to demonstrate good risk management, then information on how the bank is managing its risk exposures is pertinent. If the objective were to demonstrate *Shari'ah* compliance, then *Shari'ah* certification in the annual report and accounts as well as a description of the *Shari'ah* review programme would be of great assistance. If the objective were to demonstrate a resolution of the conflict regarding investment account holders (IAHs) resulting from the dual fiduciary role of the bank, then information pertaining to both the asset allocation and profit allocation of the bank would be extremely useful.

Under the catergories *accurate, complete*, and *credible*, it is necessary that the information is all of the foregoing so that the market may be confident in using the information. This may be achieved by means of using external parties—for example, auditors, and ratings agencies—to verify the information provided. In addition, the information should be material, be provided on a timely basis, and be easily available to the public. Here the use of the Internet, by using the bank's website, is of great importance. Furthermore, the provision of the information should not be unreasonably burdensome to the bank, especially the smaller ones. Finally, the information disclosed should not be, as far as possible, proprietary, which would endanger the competitive position of the bank. In this respect, adequate generic information should suffice (see Exhibit 22.7).

Let us now take a look at the role of the market participants in this "virtuous cycle of transparency" (see Exhibit 22.8). Here I see two main roles. First, there is the role of *disciplining institutions*, where each market develops a reputation for rewarding and punishing institutions based on information disclosed to provide an incentive for good behaviour. Reward good institutions by giving them good ratings and placing funds with them, and punish deviant institutions by doing exactly the opposite.[17]

Second, there is the role of *soliciting information*, whereby the market relays the information needs to the financial institutions. Over time, as

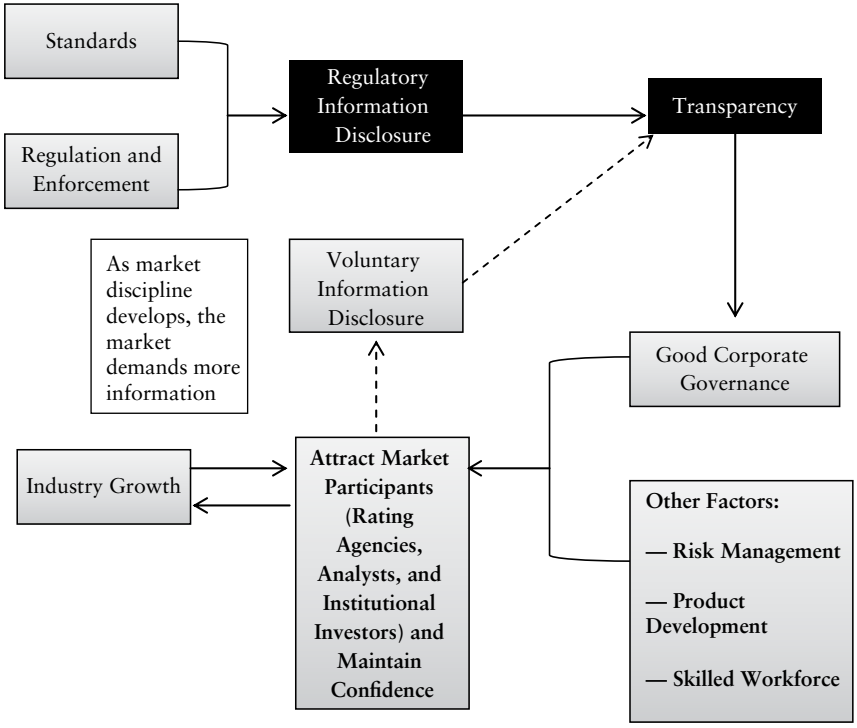


EXHIBIT 22.7 Criteria for Good Information Disclosure

market discipline develops, the potential for voluntary information disclosure, based on market demand, also increases.

4. CONCLUDING REMARKS

The Islamic finance industry has already demonstrated that it has the products and infrastructure to compete with conventional financial institutions. Annual growth rates are significant; in many markets, they are far outstripping the growth of conventional banking. However, further growth may be hampered if standard setters and regulators do not grasp the opportunity to move the industry forward by working together in implementing a strong and practical corporate governance framework, incorporating elements of global best practices.[18]

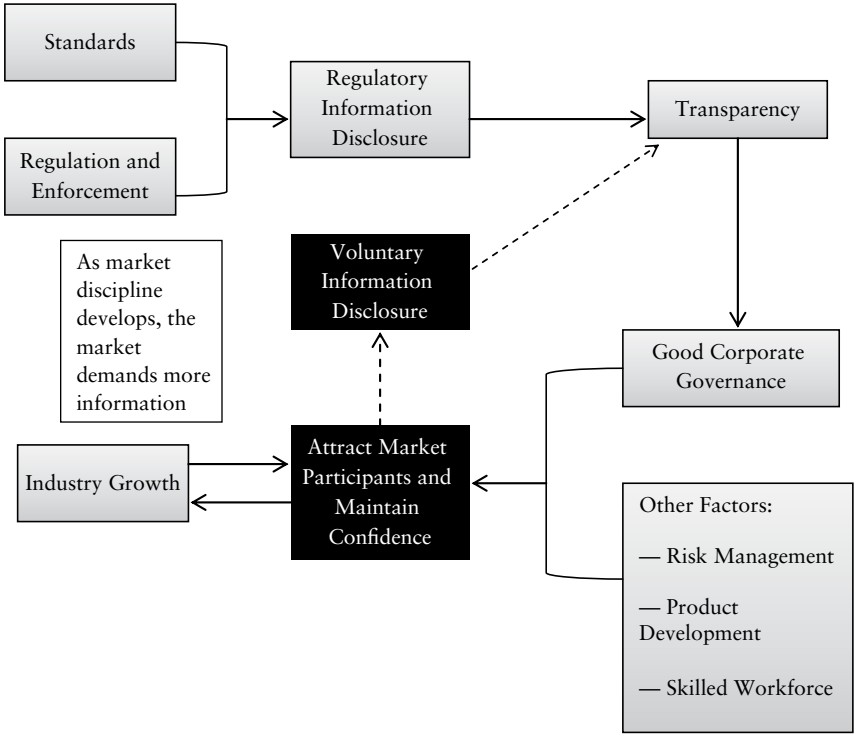


EXHIBIT 22.8 The Role of Market Participants

To date, the overall performance of the IIFS during and post financial crises, namely the Asian Financial Crisis of 1997–1998 as well as the sub-prime and global financial crises, is encouraging. As noted by the Governor of the Central Bank of Malaysia, Tan Sri Dr. Zeti Aktar Aziz, "the global financial crisis has had limited direct effects on Islamic finance. While Islamic finance by its very nature only engages in transactions that have underlying tangible productive activities, the slower overall growth and the increased uncertainties have affected pricing and activity in certain market segments. However, this in part reflects the shift in activity from the financial markets to the Islamic financial institutions."[19]

As discussed previously, a good corporate governance framework will promote transparency via information disclosure by institutions that must be credible. This will help to inspire confidence in the marketplace, promote market discipline within the industry, and ultimately serve as a catalyst to grow the industry and take it to the next level. Long journeys start with small steps, and we do not have a moment to lose!

NOTES

1. Released by the U.S. Financial Crisis Inquiry Commission on 27 January 2011.
2. See for examples, Parashar, S.P., and J. Venkatesh (2010). "How Did Islamic Banks Do During Global Financial Crisis?" *Banks and Bank Systems* 5(4), pp. 54–62; and Hasan, M., and J. Dridi (2010). *The Effects of the Global Crisis on Islamic and Conventional Banks: A Comparative Study*. IMF Working Paper no. WP/10/201.
3. Bank for International Settlements (June 2006). *Basel Committee on Banking Supervision. Part 4: The Third Pillar – Market Discipline, in International Convergence of Capital Measurement and Capital Standards*, p. 226.
4. The IFSB-4, www.ifsb.org/standard/ifsb4.pdf.
5. IFSB-4, *Disclosures to Promote Transparency and Market Discipline for Institutions Offering Islamic Financial Services (Excluding Islamic Insurance (Takāful) Institutions and Islamic Mutual Funds)*, 2007, 1.
6. Ibid., 30–34.
7. Ibid., 16.
8. IFSB-1, *Guiding Principles of Risk Management for Institutions (Other than Insurance Institutions) Offering Only Islamic Financial Services (IIFS)*. December 2005, 6, www.ifsb.org/standard/ifsb1.pdf.
9. Ibid., 19.
10. Ibid., 25.
11. Ibid., 23.
12. In a *mudarabah* contract, the *mudarib* is the entrepreneurial partner who uses the capital belonging to the *rabbul-mal* as the capital provider.
13. IFSB-2, *Capital Adequacy Standard for Institutions (other than Insurance Institutions) Offering only Islamic Financial Services*. December 2005, 19, www.ifsb.org/standard/ifsb2.pdf.
14. IFSB-4, 26.
15. See *Islamic Finance and Global Financial Stability*, 41–48.
16. The Banker, *Top 500 Islamic Financial Institutions 2011* (www.thebanker.com/Reports/Special-Reports/Top-500-Islamic-Financial-Institutions-2011), and author's own estimate.
17. It should be noted that IAH would have a very limited role in disciplining Islamic banks (see Archer, S. and R.A.A. Karim, "Corporate Governance, Market Discipline and Regulation of Islamic Banks," *The Company Lawyer* 27, no. 5 (2006), 134–145.
18. The IFSB has already started this process by issuing its various standards, guiding principles etc.
19. Governor's Keynote Address at State Street Islamic Finance Congress 2008, Boston USA—"Islamic Finance: A Global Growth Opportunity Amidst a Challenging Environment." Boston, October 6, 2008, www.bnm.gov.my/index.php?ch=9&pg=15&ac=285.

CHAPTER 23

Human Resource Management of Islamic Banks: Responses to Conceptual and Technical Challenges

Volker Nienhaus

1. INTRODUCTION

The Islamic finance sector continues to grow rapidly. Initially, the growth was driven by increasing transaction volumes of a rather small number of Islamic banks. Since the early 1990s, the number of Islamic financial institutions and the total customer base increased considerably, and the last decade saw the establishment and expansion of Islamic windows, Islamic subsidiaries of conventional banks, and the conversion of conventional into Islamic banks. In addition, global conventional players designed Islamic products for high-net-worth individuals and for institutional clients. The competition among Islamic banks and between Islamic banks on the one side and Islamic windows and products of conventional banks on the other side has been intensified substantially, with quantitative and qualitative human resource implications for Islamic banks: they need more and better-qualified personnel, which still is in short supply.

Given the competitive situation, the high growth rates of past years, the experiences of the recent financial crisis (which did not leave Islamic financial institutions untouched, albeit to a lesser degree than their conventional counterparts), and the specifics of Islamic finance, the human capital requirements are particularly high—in product development and product placement (in retail as well as investment banking), but also in risk

Islamic Finance: The New Regulatory Challenge.
Edited by Simon Archer and Rifaat Ahmed Abdel Karim
Copyright © 2013 by John Wiley & Sons Singapore Pte. Ltd.
ISBN: 978-1-118-62897-3

management, dispute resolution, and restructuring. Islamic banks' personnel must be familiar with conventional banking products and their status in relation to Islamic requirements, as well as with existing Islamic alternatives and their commercial advantages and disadvantages compared to the conventional products. Executives and staff members must be able to explain the value proposition of Islamic products to individual and institutional Muslim and non-Muslim customers. Furthermore, the management of Islamic financial institutions must be able to design *Shari'ah*-compliant financial innovations in order to meet the diversified needs of the customers and to keep up the ever-increasing scope of conventional techniques, procedures, and products. Finally, it is often claimed that Islamic banking ties finance to the real economy. Therefore, the personnel of Islamic financial institutions might need more knowledge about the nonfinancial sector than conventional bankers if they take on and hold entrepreneurial risks on their balance sheets, instead of securitising loans and selling them off as it has become the general trend in conventional banking over the last decade.

2. RECRUITMENT, RETENTION, AND QUALIFICATION OF PERSONNEL

The human resource literature usually deals with the recruitment, retention, and retirement of "human capital." Since retirement issues are not yet of major concern for Islamic banks, this topic will be ignored in the following. With respect to recruitment and retention, the following takes up topics of the conventional literature and relates them to the specifics of Islamic banking.

2.1 Broadening the Recruitment Base

Islamic banks in total can recruit personnel basically from two different groups of potential employees: first, from people seeking first-time employment; and second, from people already employed in the conventional banking sector. None of these people can generally be expected to have in-depth knowledge of Islamic finance. However, the Islamic financial sector has attracted the attention of students and practitioners who are willing to learn about its specifics—on a basic or more advanced level, and with a theoretical or practical orientation. This is substantiated by the growing number of higher education and training institutions offering an increasingly broader spectrum of study programmes and training courses:

- Several universities in Western and in Muslim countries allow for a specialisation in Islamic finance within their postgraduate programs in

accounting, banking, and finance. Others have integrated the Islamic perspective into general business administration and finance courses. Specialised MA and MS programmes in Islamic finance are offered by universities in Muslim countries as well as by Western universities (in particular in the United Kingdom).

- A wide array of programmes and training courses for professionals in banking, finance, insurance, and accounting are offered by many institutions in Europe, the Middle East, and Asia. New forms of distant learning and web-based content delivery are spreading all over the world. Main target groups are part-time students and employees of the Islamic finance industry who are looking for additional professional qualifications to promote their professional career. The number of course providers and diplomas and certificates has mushroomed so that quality assurance has become a major issue.
- The number of commercial one- or two-day seminars, conferences, and workshops on specific subjects such as *sukuk*, home purchase financing, risk management, or *takaful* has exploded.

Given the recent response of the education and training industry to the growing manpower needs of Islamic financial service providers, it seems that the number of recruitment candidates with a basic and even more specific understanding of Islamic finance is increasing and will continue to do so in the foreseeable future.

While all these initiatives have broadened the pool of talents with knowledge in Islamic finance considerably since the mid-2000s, an increasing number of graduates with academic Islamic finance degrees complain that it is difficult for them to find employment in the Islamic finance industry. This may be due to the fact that the business of many Islamic financial institutions (in particular of Islamic windows and subsidiaries of conventional banks) is largely a *Shari'ah*-compliant replication of conventional finance. If, for example, 80 percent of the transactions are commercially very similar to conventional transactions, then it can be more cost effective to hire staff with experience in conventional banking and familiarise the new employees with Islamic specifics in in-house training programmes than hiring university graduates with academic expertise in Islamic finance but limited knowledge of conventional finance and no practical experience. Providers of academic degree programmes in Islamic finance should take this into account and design their curricula accordingly. In particular, they should equip graduates to work in conventional financial institutions where they can gain the experience that will make them more attractive as recruits to Islamic financial institutions.

Although a general qualification of employees in Islamic finance is useful, it is not sufficient for Islamic banks in a competitive environment.

Their success will not depend mainly on standardised products available from many competitors, but on their own specific products. Familiarising employees with the distinct features of such products remains a prominent task of in-house training departments of each Islamic bank. The growth of external training facilities enables Islamic banks to concentrate their limited training capacities on their specifics. In-house training programmes also offer good opportunities to familiarise employees with the mission, vision, and values of the institution in order to strengthen their motivation and engagement. Unfortunately, empirical studies on the internal human resource development strategies of Islamic banks are still lacking.

2.2 Payment and Benefits

A competitive base salary has to be offered for the attraction of new employees (especially if they are to be hired away from conventional banks). Competition may force Islamic banks—at least in the medium to long term—to offer higher salaries for many positions than conventional banks, because Islamic banks require a "double" qualification of their employees in techniques of conventional banking and Islamic finance.

A competitive base pay is not only important for the first-time recruitment of employees but also for retention efforts, since it is costly to replace qualified personnel. Cost factors are not only expenses for new recruitment and training, but in particular the opportunity costs associated with the loss of the specific expertise of a leaving person. Especially in the case of middle and top managers, these opportunity costs can be considerable. The problem is aggravated further if the leaving person is a bearer of "trade secrets." Thus, in general, it makes sense to make efforts to keep qualified personnel, and retention is one of the major dimensions of human capital management.

However, Islamic banks will hardly be able to recruit and retain highly qualified employees and executives if they cannot offer, in addition to the fixed salaries, attractive performance-related rewards. A vast number of different premium and incentive schemes has been designed for the conventional finance sector. However, not all schemes are readily applicable in Islamic institutions because of *Shari'ah* or market limitations. For example, schemes of performance-related rewards for top managers and chief executives are often based on stock options. But where stocks of Islamic banks are mainly held privately, and active secondary markets are virtually nonexistent, the otherwise effective instrument of stock options cannot be applied in the Islamic financial services industry.

Without empirical research it is impossible to say how serious the problems of staff fluctuation in the Islamic financial sector are and what kind of performance-related rewards are granted. It would be illuminating to know

how many people have left Islamic financial institutions to take up new jobs either in other Islamic, or in conventional financial institutions, or in institutions of the nonfinancial sector (with or without a relation to Islam). Such figures could give an indication, for example, of the strength of the "Islamic commitment" of personnel and could shed some light on the importance of ideological factors for the human capital management of Islamic financial institutions.

The base salary is usually supplemented by other benefits for employees, including, for example, healthcare contributions, housing support, and retirement schemes. Islamic banks can also offer such benefits in principle, but the specifics of a *Shari'ah*-compliant health insurance or pension plan (as provided by *takaful* undertakings) may be more complex and difficult to explain to and be appreciated by the beneficiaries than conventional packages.

2.3 Work Environment and Motivation

Job satisfaction is a precondition for continuous and long-term employment in a company. It is the result of a complex bundle of conditions, actions, and circumstances. Islamic financial services are "ideological" products. Those involved in the production and marketing of these products should have a common and consistent understanding of the Islamic content and of its relevance. An explicit mission statement will help to clarify the main issues, to homogenise attitudes, and to motivate the personnel.

For many people, "Islamic" finance implies more than just legally interest-free contracts, and therefore an Islamic financial institution should support some "Islamic" activities outside its core business (for example, charitable events, scholarship programs, healthcare programs for the poor, Islamic art exhibitions, and so on).

A strong commitment of employees to their company will reduce fluctuations of staff, enhance the productivity of the human capital, and improve the economic performance.

- *Identification with the institution's larger goals*: It is a plausible assumption that identification with the institution's larger goals is more the case in Islamic financial institutions than in conventional ones. The reverse side of this coin is a larger potential for disappointment and frustration of personnel. The idealised view of Islamic finance, based on the theories of Islamic economics, claims that Islamic banking is superior to conventional finance with respect to efficiency (allocation), justice (distribution), and stability—provided that Islamic banking is based mainly on the sharing of entrepreneurial profits and losses of

productive activities in the real economy. This, unfortunately, is not an accurate description of the financing business of most Islamic banks. Much of Islamic banking is based on *Shari'ah*-compliant contracts for such transactions as sales on credit and leasing which allow the financier a fixed rate of return. In economic terms, such returns are somewhat similar to a form of simple interest. It took quite a while for chief executives and Muslim scholars to acknowledge the discrepancy between the idealised view and the actual practice of Islamic banking. Arguments can be found why in a transition period or in a mixed system Islamic banks cannot have recourse to the more distinctive profit- and loss-sharing instruments of Islamic finance. However, such arguments ignore the problems of asymmetric information and adverse selection, which imply that such instruments are appropriate only in particular circumstances even in widely "Islamised" systems. Nevertheless, employees and managers of Islamic banks may have a hard time explaining to sceptical clients and outside observers what the substantial difference between their modes of finance and those of conventional banks is. It needs to be more widely understood that the distinctive character of Islamic finance cannot be reduced to a mere avoidance of fixed rates of return. Arguably, more attention is required to the substance of compliance with the principles of Islamic finance and less attention to matters of mere form.

- Be that as it may, the identification of staff with the larger (systemic) goals of Islamic finance becomes more difficult when it is discovered that some Islamic financial institutions earned (or lost) much money in international commodity and currency transactions and real estate bubbles. The potential for disappointment and frustration could be reduced by more realistic and phased mission statements of the Islamic finance institutions, but also by sufficient realism in external academic and training courses and in the supportive literature.
- *Accountability versus paternalism*: In many enterprises, job satisfaction and motivation were boosted by giving more operational autonomy and responsibility to staff and lower-level managers ("decentralisation"). However, the literature on business cultures usually attests to the existence in more traditional societies of a centralised paternalistic management style. This is supplemented by the observation that in such cultures professional careers often depend less on individual performance but more on the membership of networks (defined by family relations, geographic origin, and so on), a phenomenon to which the term "nepotism" is sometimes applied. While nepotism may be seen as a means of coping with information asymmetry in labour markets ("better a mediocrity kept honest by loyalty within network relations

than a more able person with no such restraints"), it has a cost in terms of performance. More generally, the related phenomena of paternalism and "top-down" management styles have a negative effect on motivation and innovative thinking. Insofar as the more traditional societies include Arab and most other Muslim countries, the above constitutes a potential drag on the competitiveness of firms headquartered in such countries, including Islamic financial institutions.

- More insidiously, a network factor may also play a role with respect to customer-related decisions: members of some networks may get preferential treatment when it comes to the financing of projects. Paternalistic and network interventions are of particular relevance for those Islamic financing techniques based on risk and return sharing and require the assessment of business plans and project proposals. If a preferential treatment of some clients is due to an intervention from higher management levels, then equal cases are not treated equally, and the accountability for decisions becomes blurred. Such practices impede effective teamwork, undermine the idea of participation, and obstruct performance-based human capital strategies.
- Should conclusions of general studies be correct—that there is a general tendency toward paternalism and related phenomena such as rent seeking in the business culture of countries with more traditional societies—then it is of great importance that the Islamic financial institutions headquartered in such countries explicitly decide to break with such traditions and to implement safeguarding organisational structures. Further empirical studies on this topic are highly desirable but still lacking.
- *Learning traditions and use of knowledge*: Another element in some Middle Eastern and Asian societies could be an obstacle to rapid human capital development in certain countries where Islamic finance is present—namely, the general learning and education culture. The second Arab Human Development Report, published by the United Nations Development Programme (UNDP) in 2003, deals with many shortcomings of education systems based on traditional authority (accepted without reflection), learning by heart, and uncritical reproduction. If this characterises learning habits of people and if these habits did not change over the last decade, then firms within an industry operating in a dynamic environment with innovative, knowledge-based products might run into trouble if their employees have such a mindset. While such considerations are potentially applicable to all firms in such an environment, the contribution of an institution's own personnel to the evaluation and improvement of products, procedures, and strategies is much more important for Islamic banks striving for innovative

Shari'ah-compliant products than for conventional banks. But an effective contribution of the institution's own employees requires not only the readiness of hierarchically lower staff members to articulate critique but also the related willingness of hierarchically superior managers listen to critique from below and to attach a positive value to it. It seems that neither the learning culture nor the paternalistic, top-down management style typical of some societies encourages such constructive critique. Thus, in such societies there is a danger that valuable potentials of the human capital of Islamic finance institutions will not be utilised. This may be even worse in relation to *Shari'ah* boards: for regular bank personnel, well-established *Shari'ah* scholars are factually unassailable exogenous authorities.

Some of the arguments indicating potential obstacles to the unfolding of the human resource potentials of Islamic banks are a bit "soft" in terms of solid empirical support; nevertheless, fractional evidence and "industry talk" indicate that they are by no means irrelevant. The softness of the arguments is due to a huge backlog in empirical research at the firm level.

3. SUPPORT INFRASTRUCTURE FOR ISLAMIC FINANCIAL INSTITUTIONS

Many Islamic banks have the character of universal banks—that is, they provide services in a wide range of markets, from retail to investment banking. Given the scarcity of qualified personnel, it is a serious challenge to be competitive. The gathering of information and the timely dissemination of market-related and company-specific knowledge can become decisive competitive factors in a knowledge-driven industry. In recent years a number of institutions and companies emerged which provide specialised information and consultancy services for the Islamic finance industry, ranging from market data to legal advice and ratings of companies and instruments (e.g., *sukuk*). This allows especially smaller Islamic banks to replace expensive in-house activities by the purchase of external services at lower cost and/or higher quality.

3.1 Knowledge Management in the Islamic Sector

Industry-wide institutions (such as associations or federations) can improve the knowledge base and knowledge management of Islamic financial institutions—for example, by maintaining databases, disseminating best practice examples, formulating guidelines and minimum standards, negotiating with national and supranational regulators, lobbying for Islamic finance, or

conducting market research. Recourse to a high-quality support infrastructure can boost the effectiveness of the scarce and expensive human capital in individual firms of the Islamic financial services industry. The production of financial services is primarily based on financial resources and on knowledge—in particular, on the knowledge of how to mobilise and employ funds in a profitable and *Shari'ah*-compliant way, how to meet the demands of depositors and entrepreneurs, how to reconcile conflicting interests of clients, and how to adapt to legal and regulatory requirements. Not the least is knowledge of financial needs and capabilities of customers.

For its continued existence and growth, the Islamic financial sector has to manage different types of knowledge:

- *Firm-specific tacit knowledge* is company- or business-related knowledge (intellectual capital) embedded in people who work for an employer, such as an Islamic financial institution. Relevant parts of firm-specific knowledge are tacit and nontransferable: if an individual leaves the company, his or her tacit knowledge will be lost and the human capital of the company (not necessarily of the industry) will be reduced. Therefore, retention of qualified staff and executives is a prime concern if replacement costs are high (e.g., due to a general shortage of qualified people or to their particular tacit knowledge). This is particularly relevant to Islamic financial institutions whose techniques are less well documented in the academic and professional literature than those of conventional institutions.
- *Firm-specific organisational knowledge* originates from and relates to the operations of an Islamic financial services firm. It is a largely explicit and codified knowledge (for example, written down in procedural manuals, explicated in standard contracts, and so on), and it is transferable. This type of knowledge rests within the company and can be transmitted to new personnel. The organisational knowledge includes the corporate culture or the business style of a company, which may not be written down (that is, it may not be fully explicit or codified) but which nevertheless can be transmitted to new members of the organisation. The organisational knowledge manifests itself as an intangible asset that contributes to the market value of a firm.
- *Industry-specific knowledge* is shared by all Islamic financial service companies and covers those features that distinguish Islamic from conventional finance. Very often, sectoral knowledge is gathered and disseminated by industry-specific associations with a broad membership or support base from Islamic financial institutions. The dissemination of sectoral knowledge may be directed toward internal and external addressees. Internal addressees are the members of the association who receive, for example, industry data for benchmarking purposes, best

practice examples, recommendations for accounting procedures, general legal advice, or industry forecasts. External addressees receive, for example, basic facts and figures about the industry, information on job requirements and employment opportunities, or shared views and opinions on envisaged regulations. In the early years of Islamic finance (the late 1970s to the 1980s) the International Association of Islamic Banks (IAIB) played—to some degree—such a role, but with the growth and diversification of Islamic finance, it could no longer represent the majority of Islamic banks. In 2001, the General Council for Islamic Banks and Financial Institutions (CIBAFI) was set up in Bahrain with a global mission similar to IAIB. It became internationally more visible in the last years. With a national mission, the Malaysia International Islamic Financial Centre (MIFC) was launched in 2006 to promote Malaysia as a major hub for international Islamic finance. More targeted industry-specific services are provided by expert bodies for legal and accounting issues such as the Islamic Fiqh Academy of the Organization of the Islamic Conference, or the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and the Islamic Financial Services Board (IFSB) (discussed later in this chapter).

- *Customer-specific knowledge* is a firm-specific asset embedded in the human resources of an Islamic bank and relevant both for consumer banking and business finance. Some Islamic banks make efforts to become comprehensive financial service providers for retail customers. They supplement their "classic" banking services by the offer of more advanced investment and *takaful* products. In particular, the sale of complex family *takaful* products raises the human resource requirements—both with respect to product development (or product selection and purchase, e.g., in the case of *bancatakaful*) and product sales (regarding the identification of customers' needs and the explanation of complex products). In business finance Islamic banks often claim to support productive ventures of entrepreneurs in the real economy. If Islamic banks would boost their financial engagement in entrepreneurial ventures (especially on the basis of profit-sharing and risk-bearing contracts), they would need personnel with expertise and understanding of nonfinancial markets, with the ability to evaluate business plans and to assess business risks, and with a sound apprehension of the business environment of corporate customers. These are qualifications that are not taught in Islamic finance programmes, and people with such knowledge and expertise are very rare. The shortage of this kind of human resources may to some degree explain the relatively limited engagement of Islamic banks in real economy ventures apart from real estate and trade finance.

A firm's position in intra-industry competition (that is, competition among Islamic financial institutions) depends mainly on the firm- and customer-specific knowledge. Human capital management is in large part about the generation, utilisation, and retention of tacit individual knowledge. Organisational knowledge in general is a major topic of research work and consulting activities under the headlines of knowledge management and learning organisations. On the one hand, knowledge is a major input for the production of Islamic financial services. On the other hand, the generation and application of new knowledge in Islamic finance (for example, in the form of interest-free financial engineering or new laws and regulations) take place at a fast pace. Thus, Islamic financial institutions must pay attention to the knowledge dynamics in their markets and surroundings and to information and communication technologies.

3.2 External Expertise Supplementing Internal Competencies

For the growth of the whole Islamic finance industry, industry-specific knowledge becomes crucial. Activities of financial services firms in the conventional sector have contributed to and are backed by a huge knowledge base. For example, conventional banks and other financial institutions have been operating all over the world for decades (or even centuries); business practices are well documented, profit and loss accounts and balance sheets of many banks are published as time series data and subject to intense analysis and media coverage; depositors and lenders are well informed about the industry; finance and banking has grown into an advanced and diversified subject of academic teaching and research; accounting, legal, and regulatory standards have evolved gradually; banks and other financial institutions as well as money and capital markets have overcome national or regional fragmentations and form a global finance network.

Compared to this level of development, the Islamic financial services industry is still in its infancy. The number of actors as well as their sizes are relatively small; the range of products is still rather limited on the one hand but confusingly differentiated in details between banks on the other hand; comprehensive financial disclosure is more the exception than the rule; benchmarks are rare and media reports are more directed toward insiders than toward the general public; many, if not most, clients of Islamic banks have only a very limited knowledge about the specifics of Islamic finance; the academic community (inside and outside the Muslim world) is only gradually recognising Islamic finance as a subject for serious study and research; accounting practices, legal requirements, and regulatory procedures still differ considerably between countries; Islamic financial markets

are geographically still fragmented and lack the depth and sophistication of conventional financial markets, and a global Islamic finance network is a desire but not yet the reality.

Especially in such a fragmented market, independent service providers who work for several Islamic finance institutions can realise economies of scale and scope and can reduce costs and human resource requirements of smaller individual Islamic banks. Specialised companies can, for example:

- Reduce the cost of data and information collection and processing.
- Collect case studies and identify best (or worst) practice examples of techniques, operations, structures, and so on.
- Organise data and design methodologies for benchmarking and performance assessments.
- Provide expertise to Islamic banks for organisational, legal, and marketing issues.

Recourse to external service providers can enhance the efficiency of a bank's personnel in its daily operations. Gradually a support infrastructure comparable to that of the conventional finance sector is emerging. Examples of institutions and companies are as follows:

- Each financial institution has to observe its specific market segment, but for benchmarking and planning purposes it also needs more general market data. Companies with a strong reputation for data collection and processing for conventional financial markets have entered the Islamic industry. Dow Jones & Company and FTSE (a company owned by *The Financial Times* and the London Stock Exchange) publish whole families of Islamic stock market indexes. The REDmoney Group is provider of a global *Shari'ah* index series and publisher of a news journal (*Islamic Finance News*) out of a Muslim country (Malaysia). The comprehensive online Islamic Finance Information Service (IFIS) portal was set up by the Euromoney Group, and it gives subscribers access to, *inter alia*, databases on global *sukuk* issuers, *takaful*, Islamic funds, Islamic project finance, Islamic syndications, *Shari'ah* scholars, and global law firms with Islamic finance expertise. Recently Thomson Reuters started to publish the "Islamic Interbank Benchmark Rate" (IIBR), which provides an indicator of the average expected cost of short term *Shari'ah*-compliant interbank market funding.
- Accounting, auditing, and governance issues are addressed by AAOIFI from the business perspective and by IFSB from the regulators' perspective. Both AAOIFI and IFSB develop guidelines and standards for operational and structural issues. The adoption of these accounting,

auditing, and governance standards reduces the need for the development of individual solutions—that is, less manpower is needed in these fields. AAOIFI and IFSB standards are included in many academic programmes and training courses of the specialised educational and training institutions for Islamic bank personnel, and both institutions also offer training and awareness programmes of their own.

- The development of the Islamic finance industry and Islamic financial markets is the subject of teaching and research by institutions such as the Islamic Research and Training Institute (IRTI) of the Islamic Development Bank (IDB) in Jeddah or the International Islamic Universities in Islamabad and Kuala Lumpur. Industry-related programmes of higher education (leading to certified professional qualifications or academic degrees) and applied research are the mission of the International Centre for Education in Islamic Finance (INCEIF) with the International *Shari'ah* Research Academy for Islamic Finance (ISRA), established by the central bank of Malaysia. In the Gulf region, the Bahrain Institute of Banking and Finance (BIBF) established a Centre for Islamic Finance in 1997, and the Qatar Foundation has set up the Qatar Faculty of Islamic Studies (QFIS) in 2007 with an emerging research centre for Islamic economics and finance.
- More complex financial deals require special legal expertise, especially if contracts have to be in conformity both with *Shari'ah* law and the secular national or international commercial law. Specialised law firms (again mainly located in the United Kingdom and the United States, with a presence in the Middle East and Asia) provide such services. Representatives of law firms and other consultants such as accounting firms are often listed as speakers at the numerous Islamic finance seminars and conferences. The services of specialised consultants (who can exploit economies of scale and scope) allow smaller Islamic banks to participate in or even launch complex financial transactions. The cost of the employment of highly specialised experts is too high for the relatively low frequency of complex transactions in smaller banks. Similarly, the availability of external legal advice can reduce costs of the design of innovative Islamic products.

Human resource problems of Islamic banks can be mitigated by an increasing standardisation of products and techniques. When formerly firm-specific knowledge converts into industry-specific knowledge, it can be integrated into academic curricula and industry-focused training programmes of external service providers, and will gradually become common knowledge no longer requiring firm-specific investments. Besides AAOIFI and IFSB, other institutions are working on templates and framework

agreements that could reduce transaction and learning costs. For example, Hawkamah, the Institute for Corporate Governance, works on corporate governance issues in general and governance recommendations for Islamic financial institutions in particular. Of more operational relevance are the efforts of the International Islamic Financial Market (IIFM) to develop a generally applicable "*Tahawwut* (Hedging) Master Agreement" (in cooperation with the International Swaps and Derivatives Association) and to come up with a template for *Shari'ah*-compliant repo transactions. Such initiatives replace efforts of individual banks so that scarce human resources in the structuring and legal departments would be set free for more firm-specific tasks.

4. *SHARI'AH*-COMPLIANCE ISSUES

The top management of Islamic financial institutions has to identify the present and anticipate future financial needs of retail customers, entrepreneurial clients and institutional investors. This requires farsightedness with respect to trends in the national and international economy and in the Islamic and conventional financial markets. It is a major challenge for the leadership and top management of Islamic financial institutions to anticipate future needs and demands, to develop innovative products in due time, and to prepare the institution for the provision of new services. This is not different from what is expected from chief executives of conventional banks, but the scope for action of the top management of Islamic banks is more restricted than that of conventional firms: in addition to general legal requirements and state regulations, Islamic financial institutions are subject to the requirement of *Shari'ah* compliance of all products and procedures.

4.1 *Shari'ah* Scholars and *Shari'ah*-Compliance Officers

Very specific human resources, which cannot be found in conventional finance, are required to secure the *Shari'ah* compliance of all products and procedures of an Islamic financial institution. Two different types of positions have to be filled:

1. *Shari'ah compliance officers* have to ensure that all internal processes adhere to *Shari'ah*-related procedural guidelines, recommendations, and restrictions. They are employees of the bank, directly reporting shortcomings or irregularities to the board of directors and/or the *Shari'ah* board. Their role is similar to that of internal audit personnel, but in addition to qualifications comparable to a conventional internal

auditor, they must have at least a good understanding of fundamental *Shari'ah* restrictions and principles. Academic programmes or training courses for practitioners can provide the necessary knowledge for these positions. For many stakeholders of Islamic banks, the internal audit should be supplemented by a professional, external *Shari'ah* audit by an independent auditor. Most large international assurance and auditing firms with a long-established presence in the Muslim world (such as PricewaterhouseCoopers, Ernst & Young, Deloitte, or KPMG) provide such services. These firms have gained a lot of insights and expertise in past years as conventional auditors of Islamic financial institutions and as providers of advisory services to conventional banks with Islamic products or subsidiaries. Many graduates of Islamic finance programmes are absorbed by these firms.

2. *Shari'ah board scholars* are a very different breed of expert. They are responsible for the *Shari'ah* approval of products, contracts, and techniques, and they can formulate restrictions and recommendations or issue guidelines to ensure the *Shari'ah* compliance of all internal processes of the Islamic financial institutions. *Shari'ah* boards are the highest *Shari'ah* authority of an Islamic bank. *Shari'ah* board scholars must be recognised experts in Islamic commercial law and should have expertise in modern finance.

When the first Islamic banks were established in the 1970s, the shareholders installed *Shari'ah* boards and gave them the authority to decide on the permissibility of products and techniques (although *Shari'ah*-board rulings and recommendations are legally not binding because the corporate laws of most countries allocate the ultimate decision power to the board of directors). The board positions were filled with recognised *Shari'ah* authorities with expertise in Islamic contract law and contemporary finance. But the number of scholars with such a multidisciplinary qualification was rather limited, and the rapid growth of the industry led to the accumulation of large numbers of *Shari'ah* board positions by the most prominent scholars.

Top scholars hold 50 and (much) more board positions; this may be taken as an indication of a particular shortage of human resources in this area. But it could also be the result of strategic decisions of shareholders and CEOs to take (or keep) the same scholars on board as other Islamic banks with which they maintain intensive commercial relations. This may coincide with the interest of the *Shari'ah* scholars for whom board positions are not only attractive because of reputation but also financially. If the membership in a *Shari'ah* board promotes the achievement of individual goals of scholars, it is plausible to assume that *Shari'ah* board members are interested

in their reappointment. This may create a *de facto* lack of independence from the board of directors who suggests candidates and determines the remuneration, and from the shareholders who appoint the *Shari'ah* board members. In addition, *Shari'ah* board members have to be aware that the interests of the management may be well represented in the board of directors. This all leads to the hypothesis that *Shari'ah* board members will not ignore the interests of the management when they formulate a legal opinion (*fatwa*) regarding products, contracts, techniques, or procedures of their Islamic bank. This does not mean that they accept whatever new financial product or transaction is submitted by the management: it must be a prime concern of the *Shari'ah* board that the Islamic character of the institution is not questioned by the general public. But the *Shari'ah* boards must also bear in mind the commercial success of their institutions, and so they make efforts to develop *Shari'ah*-compliant functional equivalents of what the management initially had proposed.

The accumulation of 50 and more board memberships violates not only Western standards of good corporate governance (issued, for example, by the OECD or the EU), but also recommendations of AAOIFI and IFSB on the composition and procedures of *Shari'ah* boards. Only very few countries—Malaysia is the most important example—have taken measures to limit the number of board memberships and to increase substantially the number of qualified persons who could fill the board positions in a growing number of Islamic financial institutions. In general, it is a challenge and opportunity for universities with strong departments both of Islamic law and of economics and finance to launch interdisciplinary programmes for the next generation of *Shari'ah* scholars.

4.2 Changing Attitudes of *Shari'ah* Boards: From Restrictive to Permissive

In the early years, *Shari'ah* boards rejected quite a number of products and business techniques submitted by the management. But over the last decade it seems that the basic attitude of *Shari'ah* boards has changed. Their verdicts have become far less restrictive and much more permissive. Thus the spectrum of *Shari'ah*-compliant techniques and products was widened considerably.

The authority of *Shari'ah* boards of individual Islamic banks is somewhat restricted in those countries that have declared AAOIFI standards binding for their Islamic financial institutions, and in those countries that have installed national bodies as the highest authorities for *Shari'ah*-compliance assessments: for example, the Higher Sharia Supervisory Board of the Bank of Sudan (established in 1993) and the Shariah Advisory Council

of Bank Negara Malaysia (established in 1997). National boards shall ensure consistency and credibility of Islamic finance in general, which could reduce the human resource requirements of the industry. The discretionary power of individual *Shari'ah* boards of Islamic banks could be constrained if the national boards adhere to a restrictive interpretation of *Shari'ah* principles. However, if the national boards are more permissible and allow in principle a wide range of products and techniques, they *de facto* reduce their role to that of the final instance for the clarification of doubtful cases and in dispute settlement.

In a highly competitive environment, the perspectives of a bank will depend crucially on its innovative potentials. In order to keep a competitive edge and to protect against rapid imitation, neither the management nor the *Shari'ah* board of an innovative Islamic bank have an interest in too much public disclosure of the commercial and Islamic qualities of financial innovations. Islamic banking is by its character more complicated (because it has to meet the requirements of secular law and the Islamic legal system) and less transparent than conventional banking: the need to keep "Islamic business secrets" (to prevent rapid imitation by competitors) makes it more opaque than *riba*-based banking. Credibility for the Islamic qualities of the products and transactions is thus not achieved by disclosure but by the reputation and public recognition of the members of the *Shari'ah* board.

In contrast to the early years, when *Shari'ah* opinions restricted the scope of instruments and products of Islamic banks, today's *Shari'ah* boards seem to be much more permissive. A microlegalistic view has become dominant which decomposes complex financial techniques, products, and contracts into a number of basic components that resemble (or are identical with) legal figures of the traditional Islamic commercial law. The *Shari'ah* quality of these components is then assessed for each component separately. If no objections are raised against any component, the total product gets sanctioned (unless it is an obvious circumvention of the prohibition of *riba*). This method seemingly supports financial engineering and product innovation in the Islamic segment of the financial market, but it has one very serious weakness: Elements which are perfectly legitimate separately may interact in such a way that—from a macro-systemic perspective—the result may come into conflict with fundamental principles underlying Islamic law and Islamic economics. The dispute over the legitimacy of "Islamised" banking practices in Pakistan from the mid-1980s to early 1990s is a well-documented historical case, while the critique of *tawarruq* or of repurchase guarantees for *sukuk* at the issuing price are more recent examples.

It is not clear to what degree clients of Islamic banks and public opinion leaders require a very strict adherence to the substance of the rules and principles of Islamic commercial law. Rather, evidence suggests that they are

more concerned with the observance of formal Islamic legal requirements. The idealised vision of the early years has become a minority position. With conventional banks making inroads into the Islamic finance industry, managers of Islamic banks were eager to introduce *Shari'ah*-compliant functional equivalents to those structured products that have generated the highest returns (at the price of high risks) in conventional banking. The highest profits (and losses) were made by derivatives, and several Islamic financial institutions have developed (with the approval or even support of their *Shari'ah* boards) prototypes of *Shari'ah*-compliant derivatives trading techniques. These prototypes have not yet been rolled out because of some unsettled *Shari'ah* issues. But it seems that these issues are more of an operational and less of a fundamental nature: It is not the rejection of derivatives and trading in principle but the preference for their own products and techniques that so far hindered the emergence of an active market. There is also more caution in the aftermath of the conventional financial crises, but this means only a postponement and not a cancellation of plans.

Reports on ideas for *Shari'ah*-compliant trading techniques are taken by critical observers (e.g., many Islamic economists) as an indication that the present *Shari'ah* scholars are too captive in their micro-legalistic methodology to see the questionable macro-systemic implications of their *fatwas*. From this perspective it is logical to call for an additional qualification or training of *Shari'ah* board scholars in Islamic economics (or the inclusion of economists into *Shari'ah* boards—at least on the national level). This adds another dimension to the human resource requirements of Islamic banks, but it could indeed improve the consistency and credibility of the claims of a superiority of an Islamic finance system in term of allocation, distribution, and stability.

4.3 External *Shari'ah* Consultancy and Perspectives of *Shari'ah* Boards

There is a growing awareness that the authenticity and quality of Islamic finance can hardly be ensured by *Shari'ah* boards whose members are overburdened by too many board memberships, are exposed to many conflicts of interest by memberships in boards of competing companies, are fixated on a questionable micro-legalistic methodology, and are lacking a macro-systemic understanding of their micro decisions.

One way out would be a stronger role played by regulatory authorities. National *Shari'ah* boards could limit the discretionary power of individual *Shari'ah* boards—provided that the members of the national board are more restrictive than the members of individual boards. But this cannot be taken for granted, at least not for the time being. However, there is a growing

awareness of regulators that a mere microlegalistic *Shari'ah* compliance does not create a more efficient, just, or stable financial system.

Regulatory authorities should only regulate the basics and leave enough room for financial innovations. But once the basic operational tools are more or less the same for all Islamic banks, innovative products and techniques will become decisive in competition. It is hard to see where Islamic banks could make a breakthrough with financial innovations in retail banking and consumer finance. Most Islamic banks have replicated the full range of conventional services, and a commercial success in this market depends not on product innovation but on pricing and the overall service quality and customer satisfaction. The contribution of *Shari'ah* boards looks quite marginal.

Much more scope for innovation and unexploited profit potentials can be found in corporate finance, project financing and investment banking. Success in this area depends at least as much (if not much more) on the tax-saving and risk-minimising legal structure of a transaction as on its *Shari'ah* compliance. Tax issues and secular contract law are beyond the capacity of many *Shari'ah* scholars. This is where the expertise of law firms and business consultancies comes into play. They bundle top-level financial engineering with first-class *Shari'ah* expertise and intimate knowledge of relevant markets. They can take recourse to extensive experiences with conventional deals, and they have substantially upgraded their *Shari'ah* competencies over the last decade. It seems that not only their services (in particular of British law firms and American consultancies) are in increasing demand by Islamic banks in all parts of the world, but also that the most innovative deals have been structured by them. Systematic empirical studies are still lacking, but fractional evidence suggests that the importance of *Shari'ah* boards for innovations in Islamic finance decreases while law firms and consultancies take the lead. This shifts human resource requirements and worries from the Islamic finance institutions to the external consultants, and it helps to better utilise scarce top-quality human resources.

These trends, taken together, suggest that the importance of *Shari'ah* boards and individual *Shari'ah* scholars will decrease in the medium term while state-sanctioned or public authorities and specialised service providers may increasingly influence the development of the Islamic finance system. This, combined with market pressures on Islamic financial institutions to offer products that are close substitutes for conventional products, may mean that the Islamic and the conventional financial sectors are likely to move closer to each other, so that formerly clear demarcation lines become further blurred in the not too distant future. To prevent such a loss of distinctiveness in substance, the top managements of Islamic banks face a formidable challenge. In particular, they need to differentiate their products

from conventional ones by innovations that allow them to assert value propositions other than (formal) *Shari'ah* compliance. To prepare for such a positive development (or to prevent potential negative developments), future studies and scenario exercises may be needed—techniques that are not yet on the agenda of training companies, course providers, and seminar organisers.

PART

Five

Conclusion

CHAPTER 24

Concluding Remarks

Simon Archer and
Rifaat Ahmed Abdel Karim

1. INTRODUCTION

The regulatory challenge as presented in this book concerns not just the industry regulators and supervisors, and the international body they have set up, the IFSB, but the Islamic banks themselves and the governments and legislative authorities in the countries where they operate. The challenge to industry regulators and supervisors is no doubt the most obvious, in view of the characteristics of Islamic banks as both bankers and asset managers being subject to a requirement for *Shari'ah* compliance that is fundamental to their relationship with the major part of their clientele—characteristics which mean that they cannot be supervised in the same way as conventional banks. For example, in countries that do not have an integrated financial supervisor, Islamic banks may require supervision by an investment industry or securities market supervisor, as well as by a banking supervisor. The fact that Islamic finance is in a rapidly evolving stage of development, in terms of its products and techniques, adds to this challenge. For the Islamic banks themselves (or, more generally, the Islamic financial services industry sector), the challenge is to be proactive in adopting operational policies and practices that meet international standards of risk management, transparency, and corporate governance, going beyond "box-ticking" minimalist compliance, so as to facilitate the task of the industry supervisors. For both regulators and supervisors as well as for Islamic banks, the challenge is accentuated by the financial and economic crisis that began in 2007 and the subsequent reregulation of capital and liquidity requirements as set out in Basel III. In addition, structural reforms such as those proposed by the Independent

Islamic Finance: The New Regulatory Challenge.
Edited by Simon Archer and Rifaat Ahmed Abdel Karim
Copyright © 2013 by John Wiley & Sons Singapore Pte. Ltd.
ISBN: 978-1-118-62897-3

Commission on Banking in the United Kingdom and those introduced by the Dodd-Frank Act in the United States may have important implications for Islamic banks with international operations and their supervisors.

The challenge to national governments and legislative authorities has perhaps been less widely recognised and is twofold: (1) to ensure that the industry regulators and supervisors have the necessary powers to perform their functions effectively; and (2) to develop the national legal infrastructure so as to address the problem of legal uncertainty that was highlighted in Chapters 7 and 8. As regards (1), various measures are being adopted in certain Western jurisdictions such as the United Kingdom and the United States, as mentioned above, and are under discussion in the European Union. The banking systems in the Middle Eastern and Asian countries, which host the majority of Islamic banks, have been less affected by the financial and economic crisis, so that the incentive to take such measures is largely absent. In such countries, however, it is the requirement indicated in (2), namely the development of the legal infrastructure, which particularly calls for attention.

2. THE CHALLENGE TO FINANCIAL SECTOR INDUSTRY REGULATORS AND SUPERVISORS

The authors of Basel II were well aware of the supervisory burden involved in the implementation of the framework and placed emphasis, in Pillars 2 and 3, on the supervisory evaluation of risk management and corporate governance, and the roles of transparency and market discipline, in facilitating the supervisory task. Research shows that in the majority of the countries where Islamic banks operate, their transparency leaves much to be desired, and so, in parallel, does the market discipline to which they might be exposed. Typically, these countries have a weak information environment characterized by a paucity of information intermediaries; such an environment neither encourages transparency nor fosters market discipline.

One issue is that of *Shari'ah* compliance. In Chapter 12, Peter Casey discusses the issues of *Shari'ah* compliance faced by industry supervisors, which in general are not themselves qualified to judge matters of *Shari'ah* compliance as such.

Another problem is that of financial reporting standards. The International Financial Reporting Standards (IFRSs) of the IASB are deficient when applied to Islamic banks, because they do not adequately cater for the latter's *Shari'ah*-compliant financial instruments and operations. For this reason, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) was created in 1991 and has issued 26 Financial Accounting

Standards (FASTs). In spite of the high quality of these standards, however, they have been adopted in only a handful of countries. One reason for this is the belief that it is not possible for one set of financial statements to comply with both IFRSs and AAOIFI's FASTs, the priority being given to those of the IFRS. This belief, which seems to have been based on a misunderstanding,[1] is starting to have some justification as the IASB revises its standards and issues new ones (such as IFRS 7). With regard to the disclosure aspect of financial reporting, in December 2007 the IFSB issued a standard *Disclosures to Promote Transparency and Market Discipline for Institutions Offering Islamic Financial Services*, which is compatible with IAS 32 and IFRS 7.

As mentioned in Chapter 22, there is the possibility of a "virtuous circle" whereby transparency and market discipline may be "bootstrapped" by the supervisor first requiring greater transparency ("sufficient information"), while market participants (with the help of information intermediaries such as credit rating agencies and financial analysts) need to have the ability to process the information correctly. "Bootstrapping" may be expected to occur because once sufficient information becomes available, information intermediaries will start to use it and the information environment will therefore strengthen, so that in response market discipline may be expected to develop, thus encouraging further transparency.

In some jurisdictions, financial sector industry supervisors may lack the powers to apply the "arm twisting" required in order to enforce compliance. Alternatively (or additionally) they may also lack the trained personnel needed for this. Such issues are matters for governments and legislative bodies, as discussed below.

3. THE CHALLENGE TO THE ISLAMIC FINANCIAL SERVICES INDUSTRY SECTOR

The modern Western banking and insurance industries started their development over 300 years ago, in the mid-seventeenth century, when developments in mathematics and statistics provided powerful tools for financial mathematics and actuarial science, which were paralleled by the emergence of a number of major banks and of the Lloyd's insurance market in England. These tools were further developed over the following centuries, also influencing the development of economics, especially in the late nineteenth and early twentieth centuries, which saw the beginning of modern financial economics with work such as that of Jevons, Bohm-Bawerk, and Fisher. Such tools, however, were and are largely interest-based as well as having other characteristics that are not *Shari'ah* compliant.

There was no parallel development of *Shari'ah*-compliant tools in the Muslim world, then dominated (and in the Middle East and North Africa, controlled) by the Ottoman Empire, which did not accord priority to institutional development. The Ottomans, in their complacent belief that the Muslim world maintained the intellectual and cultural superiority over Western Christendom that it had possessed in the centuries preceding the Renaissance in Western Europe, did not encourage their subjects to participate in the major developments taking place in the latter.[2] This complacency extended to financial services; in the Ottoman Empire, commerce relied on forms of financing that did not involve banks as financial intermediaries, such as the use of the *mudarabah* contract.

Hence, the modern Islamic financial services industry finds itself having to devise, in the space of a few decades, *Shari'ah*-compliant alternatives to *Shari'ah*–non-compliant techniques that have evolved over more than three centuries. The challenge to the Islamic financial services industry is to achieve the rapid development of such alternatives while proactively meeting international standards of risk management and corporate governance.

A key role in these vital developments belongs to the experts in *fiqh al mua'malat* (*Shari'ah* commercial jurisprudence) on whose opinions the industry and its Muslim customers depend for assurance that the products and services offered are *Shari'ah* compliant. Such experts are generally referred to as *Shari'ah* scholars. In Chapter 9 of this volume, Yusuf Talal DeLorenzo and Michael J. T. McMillen comment as follows: "Whatever questions, reservations, or doubts the critics of modern scholarship may have on this subject, the fact that *Shari'ah* boards [composed of *Shari'ah* scholars] have been able to achieve consensus on so many key issues suffices to establish the legitimacy of modern Islamic finance, and . . . sets the stage for the establishment of industry standards which may, in turn, provide the impetus for real industry growth."

Yet, while the epithet "learned" is used to refer to lawyer members in the U.K. parliament (as in the expression "the honorable and learned member"), a practicing lawyer is required to be more than a scholar, and the continuing use of the term "scholar" to designate *Shari'ah* jurists is indicative of a problem: namely, that they commonly lack the training and experience as commercial lawyers that is expected of experts in secular commercial law, as well as the educational facilities and professional organizations through which the latter achieve professional status and maturity. This hampers the ability of *Shari'ah* jurists to play the key role that is theirs in Islamic finance. As Volker Nienhaus comments in Chapter 23 of this volume, the challenge to *Shari'ah* boards as presently constituted can come from financial and law firms who have managed to bundle top-level financial engineering with first-class *Shari'ah* expertise and intimate knowledge of the relevant markets,

backed by a financially powerful partner. By implication, this comment is also applicable to the concept of the *Shari'ah* "scholar" which still remains prevalent.

4. THE CHALLENGE TO GOVERNMENTS AND LEGISLATIVE AUTHORITIES

DeLorenzo and McMillen comment in Chapter 9 of this volume that achievement of the benefits, both macroeconomic and microeconomic, of securitisation in the field of Islamic finance will depend on, among other things, *sukuk* issues being able to obtain credit ratings from major international rating agencies, which depends, in turn, upon obtaining acceptable legal opinions on a range of true sale, collateral security, bankruptcy, and other legal issues. But they note that it is clear that such opinions are unobtainable in current circumstances, given the state of development of these legal areas in many jurisdictions within the Islamic economic sphere, and they call for action and legal reform—in particular, the reform of secular law in jurisdictions within the Islamic economic sphere.

These tasks represent a major challenge to the governments and legislative bodies in these countries, all the more in that most of them have code-based rather than common law-based legal systems. Islamic finance is essentially built on a set of (nominate) contracts, and common law jurisdictions with their law of contract seem to be more ready than code-based jurisdictions to adapt to the need to handle the legal issues raised by Islamic finance that involve the interpretation and enforcement of *Shari'ah* contracts.

One attribute that a legal infrastructure for financial transactions must possess is a reasonable degree of *legal certainty*. It is, above all, the lack of this attribute which leads to the problem noted above—namely, that of obtaining acceptable legal opinions on a range of issues such as true sale, collateral security, bankruptcy, and other legal issues, which is a requirement if Islamic finance is to develop as a fully-fledged alternative to conventional finance. From this perspective, the tradition of *fiqh al mua'malat*, with the importance given to the personal opinions of individual *Shari'ah* scholars, even if consensus between them is also accorded great importance, stands in stark contrast to the concept of "positive law" as an objective *social fact* that is prevalent in Western jurisprudence.[3] In common law-based systems, a key source of legal certainty is the principle of *stare decisis*, or judicial precedent, whereas in code law-based systems, legal certainty requires legislation—that is, the promulgation of an applicable law or legal code.

One major challenge to governments and legislative authorities is thus to find a means whereby an applicable body of "positive law" may be developed in order to provide an effective legal infrastructure for Islamic finance. Another major challenge to such authorities, as noted above, is to equip the supervisory and regulatory bodies concerned with Islamic finance with the authority and the means to perform their functions effectively.

5. CONCLUSIONS

We have summarised in this chapter what we see as the dimensions of the regulatory challenge arising out of the development of Islamic finance and the social and economic need for it to develop further. This need has a certain degree of urgency insofar as it is both unacceptable and potentially dangerous for a large section of humanity to be deprived of fully competitive financial services because of the lack of *Shari'ah*-compliant alternatives to conventional financial products and structures.

While the industry regulators and supervisors are in the front line facing this challenge, in fact the challenge is much wider, and confronts the firms competing in the industry at the micro level and the governmental and legislative authorities in the host countries at the macro level. It also confronts the profession of experts in *Shari'ah* commercial jurisprudence, and those educational institutions in which they study, with the need for a greater awareness of the characteristics required by an effective legal infrastructure for Islamic finance. This would apply in jurisdictions where the applicable law is the *Shari'ah*, as well as those mixed jurisdictions where it is partly *Shari'ah*-based and those where *Shari'ah* is not part of the legal system but where financial arrangements based on *Shari'ah* contracts need the requisite legal support.

The countries that act as hosts to Islamic financial institutions include a number of predominantly Islamic states with emerging markets, as well as other states with highly developed markets such as the United Kingdom. The challenge facing the former countries is to provide an appropriate regulatory environment and legal infrastructure, given the other pressing demands made on limited human resources. The challenge facing the latter countries is to accommodate Islamic finance within a legal and regulatory infrastructure designed for conventional finance.

A typical problem in countries with highly developed markets is the legal definition of a "bank" as a "deposit-taking institution," *deposits* having the legal status of debt contracts and being "capital certain," whereas Islamic banks accept "deposits" as profit-sharing *investment accounts* that cannot be "capital certain" as the *Shari'ah* does not permit this; in other words, if

the profit-sharing pool in which their funds are invested incurs a loss, the investment account holders must accept their share of the loss. From the narrow perspective of banking law, Islamic banks may better be termed *finance houses* rather than banks *stricto sensu*, but they perform the economic function of banks to the Islamic community and may therefore quite reasonably wish to call themselves banks for marketing reasons.[4]

Another potential problem arises from the fact that the "deposits" accepted by Islamic banks, insofar as they are a form of investment product (that is, a type of collective investment scheme—CIS), may fall to be regulated not by the banking industry supervisor but by the authority responsible for regulating CIS.[5]

One of the most egregious errors that has been committed by certain ideologists of "free markets" is the failure to acknowledge that markets (including, and indeed especially, financial markets) do not exist in a pure economic space, but are part of a societal structure of which the law and the administration of justice are key components, along with education and business ethics.[6] A major advantage of the *Shari'ah* in this respect is its insistence on the ethical dimension of business. We hope that the coming decade will see important advances in the adaptation of legal systems, in education and training, in regulation and supervision, and in other relevant aspects of institutional development, so that Islamic finance may fulfill its true potential.[7]

NOTES

1. It appears not to have been generally understood that the rules for presentation and disclosure in FASTs are compatible with those in IFRSs, in that they complement rather than conflict with those in the latter, while the rules for recognition and measurement in FASTs are, or could be applied in a way that is, compatible with those in IFRSs. However, this compatibility may be jeopardized if IFRSs are revised or new IFRSs are issued and no corresponding changes are made to the set of FASTs.
2. As noted by DeLorenzo and McMillen in Chapter 7 of this volume, the *Majalat al-Ahkam al-Adaliyah*, which was in use throughout the courts of the Ottoman Empire, was originally prepared by Ottoman scholars of the Hanafi school of jurisprudence circa 1285 CE.
3. See, for example, J. Raz, *The Authority of the Law* (Clarendon Press, Oxford, 1979). Whatever might be thought about the merits of legal positivism in general, the lack of "positive law" in commercial and financial matters is undoubtedly an obstacle to the development of financial markets.
4. In the case of the Islamic Bank of Britain (IBB), established in 2004, an accommodation was reached with the industry supervisor (the Financial Services

Authority—FSA) and IBB's *Shari'ah* advisors whereby a Muslim who opened a deposit account with the bank could waive his right to "capital certainty" following a loss. (See, for example, condition 6.3(d) in the IBB's *Young Person's Savings Account Special Conditions*.) In such a case, while it is clear that the Muslim depositor who waived his right to be repaid his capital following a loss would be in compliance with the *Shari'ah*, it is rather less clear that one could say the same in general of the types of deposit account offered by the bank. It remains to be seen to what extent this British example will be followed in other countries.

5. This was not a problem in the case of the IBB in the United Kingdom, since the FSA was a cross-sectoral regulator.
6. While the links between the development of markets and that of democratic institutions in general remain to be demonstrated, those between markets and the rule of law are being increasingly recognized.
7. The IFSB and the Islamic Development Bank (one of its member institutions) have drawn up a Ten-Year Plan for the development of the Islamic financial services industry.

Index

Accountability, 88, 431, 478, 479
Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI)
  establishment of, 179, 496, 497
  GSIFI No. 2 (*Shari'ah* review), 243, 245
  pronouncement on *sukuk*, 346
  role of, 482
  standards, 68, 232, 244, 333, 359, 392, 435.496, 436, 484, 485, 497
Advanced measurement approaches (AMA), 18, 137, 300–302, 305–309
Al-Majallah (Majelle), 172, 188
Al-mustasni' (buyer), 142
Al-sani' (seller), 142
Alternative dispute resolution (ADR), 231
Alternative standardised approach (ASA), 137, 301, 304
Altman, Edward I., 32, 33
American Insurance Group (AIG), 19, 81, 82, 96
Ancillary capital, 103, 105
Asset-backed financing, 329, 349, 376, 382
Asset-backed securities (ABS), 17, 351
Asset-backed *sukuk*, 146, 349, 375, 376, 383, 385
Asset-based financing, 98, 99, 110, 328, 329, 376, 379, 382, 460
Asset-based *sukuk*, 146, 201, 349, 353, 375, 383
Asset-liability mismatch, 14, 25, 295, 382
Asset liquidity, 327, 366, 368, 369, 374, 376, 378–380, 383
Auditing and Accounting Organisation for Islamic Financial Institutions (AAOIFI), 179
Available amount of stable funding (ASF), 25, 26

Bail-ins, 266, 283
Bank of England, 14, 47, 278, 326, 328
Banking book, 21, 62, 64, 98, 99, 136, 288, 293–295, 297, 333, 441, 456
Bankruptcy remoteness, 166, 201–204, 344, 347
Basel Committee for Banking Supervision (BCBS)
  background, 277–281, 287–289
  contingent convertible debt instruments, regulations on, 283
  corporate governance guidelines, 402, 404, 405, 412
  policy documents, 276
  Principles for the Sound Management of Operational Risk, 302
Basel I (1988), 3, 276, 278, 279, 286, 287
Basel II (2004)
  advanced measurement approaches (AMA), 18, 137, 300–302, 305–309
  alternative standardised approach (ASA), 137, 301, 304
  basic indicator approach (BIA), 17, 136, 300–303, 307, 309, 310
  business lines. *See* Business lines
  capital adequacy framework, 419
  challenges for Islamic finance, 5, 6
  credit risk, 287, 288, 300
  market risk, 3, 300
  operational risk, 134, 136, 287, 288, 299–306
  overview, 3, 4
  pillars of. *See* Pillar 1; Pillar 2; Pillar 3
  risk measurement and disclosure, 50
  risk weightings, 294, 295
  standardised approach, 15–19, 66, 137, 140, 288, 300–304, 307, 309, 310, 315
Basel III (2007)
  capital conservation buffer, 101, 102, 134, 135, 288
  capital requirements, 28, 29, 42, 43, 277, 282, 283, 288, 289
  Capital Requirements Directive (CRD IV), 15
  countercyclical capital buffer, 135, 289
  high quality liquid assets (HQLA), 9, 22–25, 27, 65, 135, 334, 335
  and Islamic banks/finance, 5, 27, 42–48, 50, 53, 65, 91, 101, 102, 289–294
  leverage ratio, 23, 24, 30, 135, 282, 289
  liquidity, 276, 282, 326
  liquidity coverage ratio (LCR), 24, 25, 27, 30, 135, 282, 334
  liquidity risk, 22, 23, 50, 133
  liquidity risk and *Shari'ah*-compliant banks, 27
  market risk approaches, 3
  net stable funding ratio (NSFR), 25, 26, 30, 135, 282, 334
  new regulatory requirements, 4, 5, 15, 276
  objective of, 276

Islamic Finance: The New Regulatory Challenge.
Edited by Simon Archer and Rifaat Ahmed Abdel Karim

Copyright © 2013 by John Wiley & Sons Singapore Pte. Ltd.

ISBN: 978-1-118-62897-3

Basel III (2007) (*continued*)
operational risk, 133–136
overview, 3, 4
pillars of. *See* Pillar 1; Pillar 2; Pillar 3
risk management framework, 29–38
stress testing, 29, 38, 39, 41, 136. *See also* Stress testing
tiers of capital, 288
timeline for implementation, 29, 30
Basic indicator approach (BIA), 17, 136, 300–303, 307, 309, 310
Basis risk, 64, 65
Bay' al-'inah, 248
Bay' al-murabahah, 248
Beximco v Shamil Bank (2004), 230, 231
Board of directors, 39–41, 402–404, 406, 413, 488
Business lines, 17, 18, 29, 66, 137, 140, 302–311, 315–317, 333, 407

Capital adequacy, 9, 36, 42–48, 95, 101, 102, 140, 275–297, 310, 454, 455
Capital adequacy ratio (CAR), 51, 52, 277, 287, 289, 292, 293, 297
Capital conservation buffer, 101, 102, 134, 135
Capital markets, 10, 15, 166, 198–201, 353, 365–385, 387–395. *See also Sukuk*
Capital Markets and Services Act 2007 (CMSA), 390, 393
Capital structure of Islamic banks, 7, 42, 43, 95–102, 105, 454
Capital structure of *takaful* (Islamic insurance) firms, 7, 95, 96, 102–105
Central Bank of Bahrain, 349, 357, 359
Central Bank of Malaysia Act (2009), 394
Central counterparty clearing (CCP), 19
Centre for Islamic Finance, 485
Chief risk officer (CRO), 407, 413
Choice of law, 206
Clawbacks, 408, 410, 413
Closed-end funds, 387, 388
Codes of corporate governance, 402, 404, 407. *See also* Corporate governance
Collateralised debt obligations (CDOs), 13, 82, 325, 411, 412
Collective investment schemes (CISs), 5, 50, 368, 387, 388, 392, 426, 440, 441, 457, 460, 501
Commingling of funds, 50, 54, 68, 99, 203, 204, 290–292, 420, 423, 427, 430, 433, 434, 438
Commodity *murabahah* transactions (CMT), 100, 101, 141, 142, 158, 229, 266, 291, 297, 327, 327, 334
Commodity price risk, 22, 61, 66, 436, 437
Compilation Guide for Financial Soundness Indicators (IMF), 63
Contingent capital, 28, 42, 43, 276, 282, 283
Contingent convertible debt instruments (CoCos), 43, 283
Conventional banks
accrual basis accounting, 158
credit risk, 58, 59
and global financial crisis, 42, 107
gross income, 136
interest rate risk in the banking book, 99
Islamic products and Islamic banking windows, 154, 187, 188, 473, 490
market risk, 63, 109, 110
mortgage lending, 108
rate of return on deposits, 67
and risk attitudes, 84
risk management, 96
risk transfer, 87
Corporate governance, 10, 11, 401–413, 417–443, 452, 470, 486
Counterparty risk, 19, 36, 81, 86, 109, 125, 229
Credit concentration risk, 20, 62
Credit default swaps (CDSs), 83, 84, 87, 95, 96, 411
Credit rating agencies, 17, 23, 166, 198, 201, 203, 204, 206, 207, 280–281, 497, 499
Credit ratings, 59, 82, 90, 148, 198, 240, 287, 288, 330, 333, 384, 412, 499
Credit risk, 7, 16, 17, 21, 22, 58–62, 109, 112–130, 149, 226, 294, 295, 455
Credit scoring models, 17, 32–34
Credit spread (CS), 17, 23, 35, 48
Credit VaR, 32–35
Currency and funding mismatches, 367, 368
Current accounts, 50, 65, 68, 99, 140, 420, 423, 424, 428, 440, 462

Dale, Richard, 32
Dalil, 179
Data for operational risk measurement, 310–312
Debt financing, 405, 406
Deposit insurance, 361, 406, 431, 432, 439, 463
Derivatives, 4, 15, 19, 36, 79–88, 109, 110, 171, 187, 188, 289, 329, 346, 388, 486, 490
Disclosures, 21, 22, 27, 50, 55, 56, 435, 436, 453–467, 497
Discount window, 44–46
Displaced commercial risk (DCR), 50, 51, 99, 100, 110, 111, 226, 291, 292, 295
Dispute resolution, 197, 226, 229–233
Documentation, 157, 158, 228, 229, 242, 243, 246–249
Dodd-Frank Act of 2010, 15, 410, 496
Dow Jones & Company, 186, 484

Economic capital framework for risk assessment, 36–38
Economic stability, 78, 81, 82, 88, 89, 92

Education and training programs, 474, 475, 479, 480, 485
Emerging economies, 46, 371, 373
Enforceability (remedies) opinions, 165, 195–198, 209–216
Enterprise risk management (ERM), 29, 31–33, 35–38, 334
Equity-based contracts, 58, 62, 63, 66. *See also* *Mudarabah* contracts; *Musharakah* contracts
Equity position in banking book, 62, 98, 293, 294, 456
Equity position risk, 22, 62, 98, 287, 293, 294, 456
Ethics, 77, 88, 252, 390, 418, 426, 501
European Central Bank (ECB), 14, 23, 92
Executive compensation, 403–404, 407–411, 413, 476, 477
Expected loss (EL), 37, 58–60, 62, 95, 305–307, 313
Expert judgment model, 313
Expert systems, 33, 34
Exposure at default (EAD), 16, 59–61
External audit, 487

Factoring, *Shari'ah*-compliant, 187
Fair value accounting, 333, 334
Fannie Mae (Federal National Market Association), 199
Fatwa (legal opinion), 169, 186, 375, 488
Federal Reserve (U.S.), 14, 81, 278
Fiduciary duties, 91, 99, 103, 138, 139, 145, 152, 369, 418, 422, 425, 426, 432, 440, 462, 468
Fiduciary risk, 56, 58, 139, 145, 225, 301, 311, 424
Fima anfaqahu, 241
Financial Accounting Standards (FASTs), 496, 497
Financial Stability Board (FSB), 5, 265, 267, 271
Financial Stability Forum, 329
Fiqh (Islamic jurisprudence), 53, 167, 172, 226–228, 230, 231, 233, 239
Fiqh al-mu'amalat (Islamic commercial jurisprudence), 232, 326, 498, 499
Fiqh al-muwazanah (weighing benefit and harm), 251–254
The First Crash (Dale), 32
Foreign exchange risk, 22, 279, 287, 462
Framework of the Rate of Return, 68
Freddie Mac (Federal Home Loan Mortgage Association), 178, 199
FTSE, 484
Fund management, 50, 99, 187, 317, 388, 391, 421, 422

G10 countries, 5, 278, 281
G20 countries, 5, 267, 282, 329
Gambling, 84, 85, 92, 239, 247, 344. *See also* *Gharar* (uncertainty); *Maysir* (speculation)
General Council for Islamic Banks and Financial Institutions (CIBAFI), 482
Generally accepted accounting principles (U.S. GAAP), 271, 413
Ghalat (mistake), 242
Gharar (uncertainty), 84, 108, 228, 239, 241, 242, 250, 326, 329, 346, 380
Ghubn (gross overcharging), 242
Ghurm bil ghunm, al- (liability goes with profit), 239
Ginnie Mae (Government National Mortgage Association), 199
Global economy, 7, 13, 14, 77–84, 88–91
Global financial crisis, 7, 81, 82, 88, 264–271, 275–284, 327, 451–452, 470
A Global Regulatory Framework for More Resilient Banks and Banking Systems. *See* Basel III
Global systemically important financial institution (G-SIFI), 266, 276, 282, 283
Globally Significant Financial Institutions (GSFI), 28
Governance, 268, 269, 391–395. *See also* Corporate governance
Government bailouts, 401, 402, 407, 408
Government bonds, 23, 47, 48, 320, 328. *See also* *Sukuk*
Guidelines on Islamic Fund Management, 391
Guiding Principles on Conduct of Business for Institutions offering Islamic Financial Services (2009), 392
Guiding Principles on Governance for Islamic Collective Investment Schemes, 392

Hadith, 108, 238, 240, 241
Halal, 230, 241
Haram, 108, 115, 230
Hedging instruments, 376, 377
Hedging Master Agreement *(Tahawwut)*, 486
Hifz al-mal (protection of wealth), 238, 240, 257
High quality liquid assets (HQLA), 9, 22–25, 27, 65, 135, 330, 334, 335
Home financing, 178
Human resource management, 473–492. *See also* Executive compensation
Hutcheson, Archibald, 32, 33

IAH. *See* Investment account holders (IAHs)
IAS 32, *Financial Instruments: Presentation*, 100, 497
IFRS 7, *Financial Instruments: Disclosure*, 456, 497
Ijarah contracts
  credit risk, 109, 120–122, 294, 461
  enforceability opinion (legal opinion), 196, 209–216
  exposure at default (EAD), 60
  market risk, 97, 98, 120–122

Ijarah contracts (*continued*)
modern contracts, development of, 172, 178
operational risk, 138, 143, 144, 157
profit-sharing, 54
PSIA funds invested in, 290, 332, 420
returns on, 295
and risk-weighted asset calculations, 289
separateness covenants for securitised assets, 204
sukuk, 349–351, 353, 354
use of, 420
validity of, 241, 248, 255
Ijarah muntahia bittamleek (IMB), 97–99, 120–122, 143, 144, 294, 436
Ijma', 179
Ijtahad, 172
Ijtihad, 172
Ijtna', 180
Ikrah (duress), 242
Independent Commission on Banking (ICB), 15, 496
Individual Capital Adequacy Assessment Process (ICAAP), 20, 38, 39
Individual Liquidity Adequacy Statement (ILAS), 20, 38, 39
Information technology and systems (ITS) risk, 7, 8, 139, 153–161
Infrastructure financing, 342, 347, 352, 361, 371, 375, 376, 378, 382, 383
Inherent risk in Islamic financial institutions, 107–130
Insolvency, 37, 53, 60, 101, 140, 202, 203, 226, 228, 266, 283, 405, 406, 463
Institute for Corporate Governance (Hawkamah), 486
Interest, prohibition on, 77, 108, 169, 242, 247, 328, 419, 489. *See also Riba*
Interest rate risk, 22, 99, 279, 287, 294, 295, 376, 382, 456
Interest rate risk in banking book (IRRBB), 99, 294, 295, 441, 456
Internal audit, 8, 32, 244, 245, 314, 315, 412, 487
Internal models approach, 19, 456
Internal ratings-based (advanced) approach, 15, 16, 454
Internal ratings-based (foundation) approach, 15, 16
Internal ratings-based (IRB) risk weightings, 101, 102. *See also* Risk-weighted assets (RWA)
International Accounting Standards Board (IASB), 100, 497
International Association of Insurance Supervisors (IAIS), 271
International Association of Islamic Banks (IAIB), 482
International Centre for Education in Islamic Finance (INCEIF), 485
International Convergence of Capital Measurement and Capital Standards: A Revised Framework. *See* Basel II
International Financial Reporting Standards (IFRS), 23, 44, 271, 332, 334, 413, 456, 496, 497
International Islamic Financial Market (IIFM), 380, 486
International Islamic Liquidity Management Corporation (IILM), 42, 45, 48, 296, 330, 329, 334, 384
International Islamic Universities, 485
International Monetary Fund (IMF), 6, 267, 271, 283
International Organization of Securities Commissions (IOSCO), 271, 388, 389, 418
International Securities Dealers' Association (ISDA), 380
International *Shari'ah* Research Academy for Islamic Finance (ISRA), 485
International standards, 267, 271, 277, 278, 281, 282
International transactions and *Shari'ah* compliance, 180–186
Investment account holders (IAHs), 50–52, 54–58, 67–71, 145, 152, 159, 160, 418–443
Investment banking, 291, 379, 388, 480, 491
Investment risk reserve (IRR), 56–58, 67–69, 292, 420, 429, 431, 432, 439, 441, 460, 461
Islamic banking windows, 154, 266, 457, 475
Islamic banks
capital adequacy, 42–48, 101, 102, 289–294, 310
capital structure, 7, 42, 43, 95–102, 105, 454
characteristics of, 419–425
corporate governance. *See* Corporate governance
establishment of and Islamic jurisprudence, 169–171
global economic conditions, effect of, 42
liquidity issues, 43–48
operational risk, 137–140, 300, 301. *See also* Operational risk
risk environment in banking, 42–48
Islamic bonds. *See Sukuk*
Islamic contracts. *See also* specific contracts
capital impairment risk, 98
commercial risk, 99, 100
credit risk, 98
defects, critical, 247, 255
defects, remediable, 247–249
history of, 172–175
international transactions, 180–186
and Islamic jurisprudence, 163–179, 207, 208
market risk, 96–99
non-compliant contracts, rectification of, 254, 255
overview, 420

pillars of, 241
profit-sharing investment accounts. *See* Profit-sharing investment accounts (PSIA)
risk and risk measurement, 54–67
valid *(sahih)* and invalid *(ghayr sahih)* contracts, 249, 250
void *(batil)* and defective *(fasid)*, 250, 251, 254, 255
Islamic Development Bank (IDB), 5, 45, 53, 54, 359, 392, 463, 485
Islamic finance
education and training, 474, 475, 479, 480, 485
and enforceability of the *Shari'ah*, 165, 179–195, 208
growth of, 340, 361–363, 385, 473
and Islamic jurisprudence, 163–179, 207, 208, 227, 228, 499, 500
legal opinions, 195–198
real economy basis, 46, 77, 86–90, 326–328, 335, 347, 474, 478, 482
regulatory challenges, 495–500
revival and recovery period, 164, 169–171, 174, 175, 179
and risk, 84–92
transformation and adaptation period, 164, 174, 178–188
transparency and market discipline issues, 457–470. *See also* Market discipline
Islamic Finance Information Service (IFIS), 484
Islamic Finance News, 484
Islamic finance products
lack of standardisation, 44
policy recommendations, 51, 52, 70, 71
product development, 176, 186–188, 374–377, 474, 476, 482
risk characteristics of, 7, 49–54, 69, 70
risk mitigation approaches, 31, 67–69
sukuk. *See Sukuk*
types of risk, 54–66
Islamic Financial Services Board (IFSB)
and Basel guidelines, 133, 134
capital adequacy formula, 54, 69, 70
capital adequacy standard, 97, 99, 101, 102, 140, 151, 269, 289, 292–294, 309, 310, 456
Disclosures to Promote Transparency and Market Discipline for Institutions Offering Islamic Financial Services, 457–467, 497
establishment of, 5, 6, 54, 179, 360
governance committee proposal, 269
Guidance on Disclosures to Promote Transparency and Market Discipline for Institutions Offering Islamic Financial Services (2007), 442, 453, 456
Guiding Principles of Liquidity Risk Management, 150
Guiding Principles of Risk Management, 245
Guiding Principles on Liquidity Risk Management for Institutions Offering Islamic Financial Services, 296
Guiding Principles on Shari'ah Governance Systems for Institutions Offering Islamic Financial Services, 245, 246
IAH operational risk, 145, 152
liquidity management taskforce, 384
objectives of, 392
operational risk, 133, 134, 137, 140, 300, 309, 310
revised supervisory review process, 151
risk management (IFSB 2005a), 54
role of, 6
solvency and capital requirements for *takaful*, 103, 104
standards, 4, 6, 52, 54, 62, 69, 70, 150–152, 289, 360, 392, 484, 485
stress testing, guiding principles, 150, 151
sukuk, exposure draft on, 146
Islamic Fiqh Academy of the Organization of the Islamic Conference, 482
Islamic Inter-bank Money Market (IIMM), 382
Islamic Interbank Benchmark Rate (IIBR), 484
Islamic Interbank Offer Rate (IIBOR), 384, 385
Islamic law. *See also Fiqh* (Islamic jurisprudence); *Hadith; Shari'ah*
Islamic jurisprudence and Islamic finance, 163–179, 207, 208, 227, 228, 499, 500
maqasid al-Shari'ah (objectives of Islamic law), 238–240, 242, 251, 252, 257
profits and liability, 85
prohibition of excessive risk-taking and gambling, 84, 85, 238–240
rights and obligations, balance of, 85
Islamic money markets, 265
Islamic Research and Training Institute (IRTI), 485
Istisna'a contracts
band al-jazza penalty clauses, 228
cancellation risk, 65
credit risk, 58, 109, 118, 119, 461
documentation and legal risk, 228
exposure at default (EAD), 60
infrastructure projects, 383
istisna'a-ijarah, 181, 182
liquidity risk, 65
market risk, 118, 119
modern contracts, development of, 178
operational risk, 138, 142, 143, 147, 157
profit-sharing, 54, 332
real estate investment, 147, 181, 182
and risk-weighted asset calculations, 289
Sharia'ah compliance, 241
sukuk, 349, 352–354
use of, 420

Istisna'a-ijarah, 181, 182
Istisna'a sukuk, 352–354

Jarrow, Robert A., 17, 32, 35
Jehala (ignorance), 326
Judgments and awards, enforceability of, 206, 207

Key risk indicators (KRIs), 18, 313
Kharaj bi al-daman, al- (profit goes with liability), 239
Kharaj bidhaman, al-, 85
Khiyar (option right), 239

Lease-to-purchase. *See Ijarah muntahia bittamleek* (IMB)
Leased asset-based contracts, 66, 97, 98. *See also Ijarah* contracts
Legal certainty, 499
Legal compliance, 8
Legal opinions, 195–198, 202–207, 209–216
Legal risk, 8, 225–233, 299
Lehman Brothers, 13, 22, 81, 95
Lender of last resort (LOLR), 65, 265, 382
Leverage, dangers of, 90, 91
Leverage ratio, 23, 24, 30, 135, 282, 289–291
Liabilities (deposits) as liquidity, 331–333
Lines of business (LOBs). *See* Business lines
Liquidity, 43–48, 325, 326, 365–366, 368–370, 374, 376, 378–380, 383
Liquidity coverage ratio (LCR), 24, 25, 27, 30, 135, 282, 334
Liquidity risk
  asset-based financing, 328, 329
  asset liquidity, 326
  Basel requirements, 22–25, 27, 30, 50, 133, 135, 276, 282, 294–296, 333, 456
  defined, 325
  and fair value accounting, 333, 334
  government bonds, 328
  International Islamic Liquidity Management Corporation. *See* International Islamic Liquidity Management Corporation (IILM)
  liabilities (deposits) as liquidity, 331–333
  liquidity measures. *See* Liquidity coverage ratio (LCR); Net stable funding ratio (NSFR)
  overview, 9, 325
  regulatory response to, 325, 326, 335, 336
  and *Shari'ah* principles, 226, 334, 335
  trade finance assets, 327, 328
Long-term stable funding ratio, 268
Loss distribution approach (LDA), 305, 306, 313
Loss-given default (LGD), 16, 33, 35, 59–61, 63

Macroprudential regulation, 264
Madhhab, 228, 231
Majallah, al- (Majelle), 172, 188
Malaysia, 48, 54, 247, 249, 253, 329, 330, 341, 342, 350, 352–356, 358–359, 362, 382, 390–395, 418, 430, 466, 482, 484–485, 488, 489
Malaysia International Islamic Financial Centre (MIFC), 482
Maqasid al-Shari'ah (objectives of Islamic law), 238–240, 242, 251, 252, 257
Market discipline, 21, 22, 434–440, 452–470, 497
Market participants, 373, 376, 378, 379, 468–470
Market risk, 7, 18, 19, 22, 97–99, 109, 110, 112–130, 455, 456
Maslahah, 251–253
Mathematical models, 313
Maturity mismatches, 22, 326
Maysir (speculation), 85, 108
Measurement models for operational risk, 310, 313
Merton, Robert C., 16, 32, 34
Min aina iktasabahu, 241
Modern era of Islamic economy, 163, 164
Mohd Alias bin Ibrahim v. RHB Bank Berhad and Another, 394, 395
Money markets, 63, 65, 226, 265, 368, 372, 381, 382, 384
Monitoring of operational risk measurement model, 310, 313–315
Moral hazard, 80, 86, 145, 286, 290, 292–293, 405, 406, 412, 431
Mortgage-backed securities (MBS), 13, 24
Mortgages, 178
Mu'amalat (transactions), 172
Mudarabah contracts
  accounting standards, 68, 69
  credit risk, 127–130, 461
  equity risk, 62–64
  information technology and systems (ITS) risk, 157–160
  investment accounts and governance issues, 420–427, 431, 439, 441, 442
  market risk, 99, 100, 127–130
  modern contracts, development of, 178
  operational risk, 66, 138, 145
  profit sharing, 50, 54, 99, 100, 240
  rate of return risk, 64, 99, 100
  risk, 50, 51, 54–58
  risk measurement, 68–70
  risk weighting, 289, 293–294
  short-term financial instruments, 382
  sukuk, 352, 353, 421
  takaful firms, 103. *See also Takaful* (Islamic insurance)
  two-tier, 332
Mudarib, 50, 54, 56, 58, 68, 69, 99, 110, 111, 127–130, 138–140, 145, 152, 292, 293, 421, 422, 424–431, 438, 462

Multivariate models, 32
Murabahah contracts
  and asset liquidity, 327
  back-to-back *murabahah*, 178
  cancellation risk, 65
  commodity *murabahah* transactions (CMT), 100, 101, 141, 142, 158, 229, 266, 291, 297, 327, 328, 334
  commodity price risk, 66
  credit risk, 58–62, 109, 113–115, 294, 461
  critical defects, 247
  displaced commercial risk, 110, 111, 295
  documentation and legal risk, 228, 229
  infrastructure projects, 383
  liquidity risk, 65, 327
  market risk, 64, 97, 99, 113–115
  modern contracts, development of, 174, 178
  murabahah li'l-amir bi'sh-shira, 174, 178
  operational risk, 138, 141, 142, 157
  parallel *murabahah*, 178
  pillars of, 241
  profit-sharing, 54, 332
  PSIA funds invested in, 290
  rate of return risk, 64
  return on, 430
  reverse *murabahah*, 178, 327
  reverse parallel *murabahah*, 178
  risk and risk measurement, 54, 58–61, 64–66
  Shamil Bank v. Beximco, 165, 190–195, 208
  Sharia'ah compliance, 241
  sukuk, 355, 357, 358, 383
  use of, 97, 420
Murabahah li'l-amir bi'sh-shira, 174, 178
Musaqah contracts, 240
Musharakah contracts
  credit risk, 109, 123–126, 461
  displaced commercial risk, 110
  equity risk, 62–64
  market risk, 64, 98, 123–126
  modern contracts, development of, 178
  operational risk, 144, 147
  profit sharing, 54, 240
  rate of return risk, 64
  real estate investment, 147
  risk weighting, 289, 293–294
  sukuk, 248, 349, 352
  use of, 420
Mustasni', al- (buyer), 142
Muwakkil (principal), 149
Muzara'ah contracts, 240

Net stable funding ratio (NSFR), 25–26, 30, 135, 282, 334
Neural networks, 34
Nominate contracts. *See* specific contracts

OIC Fiqh Academy, 179
Operational risk, 7, 9, 17–18, 22, 66, 133–152, 270, 288, 294, 299–322, 456
Option-based models, 16, 32, 34, 35
Organisation for Economic Co-operation and Development (OECD), 281, 401, 404, 405–413, 488
Ottoman Empire, 172, 188, 498

Parallel *istisna'a*, 118, 119, 142, 143
Parallel *murabahah*, 178
Parallel *salam*, 142, 437
Partnership-based contracts, 96, 98, 99, 108, 123–125, 144, 156, 241, 345, 349, 376, 422. *See also Mudarabah* contracts; *Musharakah* contracts
Performance assessment, 36, 484
Pillar 1 (minimum capital requirements), 4, 15–19, 280–282, 300
Pillar 2 (supervisory review), 4, 5, 20, 280–282, 294–296, 404, 405
Pillar 3 (market discipline), 21, 22, 280–282, 434, 452–466
Policyholders' risk fund (PRF), 103–105
Principles for Enhancing Corporate Governance, 411
Principles for the Sound Management of Operational Risk, 302
Principles of Corporate Governance, 405
Private equity investments, 186, 187, 388
Probability of default (PD), 16, 33, 35, 59–61
Profit and loss sharing (PLS), 44, 240, 293, 418–420. *See also* Partnership-based contracts
Profit equalisation reserves (PER), 56–58, 67–69, 292, 332, 420, 429–432, 439, 441, 460, 461
Profit-sharing investment accounts (PSIA), 49–52, 99–100, 110, 111, 266, 269, 270, 289–297, 332, 333, 500, 501. *See also Mudarabah* contracts; *Wakalah* contracts

Qard (interest-free loan), 103–105, 148, 149
Qatar Faculty of Islamic Studies (QFIS), 485

Rahn (mortgage and pledge), 205
Rate of return risk, 64, 441
Re-*takaful*, 104, 105
Real economy and Islamic finance, 46, 77, 86–90, 326–328, 335, 336, 347, 474, 478, 482
Real estate investment, 147, 148, 180–182, 187
Recessions, 13, 14, 77
REDmoney Group, 484

Reduced form (empirical) models (intensity-based models), 17, 32, 35
Regulation
  Basel Accords. *See* Basel I; Basel II; Basel III
  capital market. *See* Capital markets
  challenges for Islamic financial services industry, 495–500
  corporate governance, 402–404. *See also* Corporate governance
  globalisation of, 275, 281, 282
  regulatory response to liquidity risk, 326, 327, 334, 335
  risk-based approach, 275, 278–281
  scope of, 266, 267
  and supervision, 261–271
Remuneration practices, 403, 404, 407–411, 413, 476, 477
Repurchase (repo) transactions, 43, 44
Reputation risk, 20, 65, 134, 137, 139, 149, 246, 257, 270, 294, 299, 412, 423, 425
Required amount of stable funding (RSF), 25, 26
Reverse commodity *murabahah* transactions (CMT), 100, 101
Reverse parallel *murabahah*, 178
Reverse stress test, 41
Riba, 84, 85, 88, 108, 148, 169, 226, 242, 247, 250, 328, 419, 489
Riba al-fadl, 329
Riba al-nasiah, 329
Ribhu ma lam yudhma, 85
Risk, 78, 80–92, 275–284. *See also* specific types of risk
Risk-adjusted rate of return, 36
Risk analytics, 29, 31
Risk and return, Islamic perspective on, 77, 84–88, 92, 238–240
Risk appetite, 36, 83, 84
Risk categories, correlations between, 35, 36
Risk committee, 404, 405, 407, 409, 413
Risk environment in banking, 7, 13–48
Risk management, 31, 36, 67–69, 140, 141, 238, 239, 376, 377, 405–407
Risk measurement, 50, 54–67
Risk mitigation, 5, 49, 51, 53, 67–69, 79, 80, 114–116, 118, 120, 121, 123, 125, 229, 238, 256, 289, 455, 461
Risk sharing, 49–52, 54–58, 67–71, 240
Risk transfer, 79, 80, 82–84, 86, 87, 147, 240, 346
Risk-weighted assets (RWA), 28, 51, 52, 55, 70, 99, 101, 282, 287, 289, 293, 462. *See also* Capital adequacy ratio (CAR)
Risk-weighted capital, 269, 278, 282
Rome Convention, 192, 194, 227
Royal Bank of Scotland (RBS), 13, 407

Salam contracts
  commodity price risk, 66, 436, 437
  credit risk, 58–62, 109, 116, 117, 436, 461
  liquidity risk, 65
  market risk, 97, 116, 117
  modern contracts, development of, 178
  operational risk, 138, 142
  profit-sharing, 54
  PSIA funds invested in, 290, 332
  risk, 54
  and risk-weighted asset calculations, 289
  Shari'ah compliance, 241
  sukuk, 355–357, 383
  use of, 97, 420
Sales-based contracts, 58–62, 66, 97. *See also* *Istisna'a* contracts; *Murabahah* contracts; *Salam* contracts
Sani', al- (seller), 142
Sarbanes-Oxley Act, 410
Scenario analysis, 29, 40, 41, 150, 251, 252, 302, 305, 310, 312–314
Secondary markets, 65, 166, 198–201, 330, 346, 353, 372–374, 376–380, 382–384, 476
Securities Industry Development Corporation (SIDC), 358
Securitisation, 9, 10, 22, 329, 339, 357–363, 376, 455. *See also Sukuk*
Sensitivity analysis, 41
Shadow banking, 266
Shamil Bank v. Beximco (2004), 165, 190–195, 208
Shareholders and corporate governance, 401, 403, 405–410, 413, 417, 418, 420–435, 438. *See also* Corporate governance
Shari'ah
  classical contracts (nominate contracts), 172–177
  commercial law, 164, 167–169
  compliance, 240–243, 486–492
  compliance officers, 391–393, 486, 487
  compliance review, 243–246
  enforceability of, 165, 179–195, 208
  enforceability (remedies) opinions, 165, 195–198, 209–216
  and establishment of Islamic banks, 169–171
  finance products, 374–377
  governance, 263, 391–395
  and international transactions, 180–188
  and Islamic jurisprudence, 163–166
  and liquidity risk, 226, 326, 327, 334, 335
  modern contracts, development of, 178, 179
  and modern trade and commerce, 168, 169, 171, 172
  non-compliance risk. *See Shari'ah*-non-compliance risk
  overview, 167, 168

scholars *(ijtna')* and jurists, 164, 167–172, 175, 177–180, 186, 187, 200, 230, 239, 263, 301, 375, 377, 392, 394, 480, 486–488, 490, 491, 498, 499
Shari'ah-incorporated jurisdictions and secular jurisdictions, 188, 189
sukuk, 166, 178, 181, 182, 198–208. *See also Sukuk*
supervisor's role, 262, 263
supervisory boards, 172, 174–178, 181, 243–245, 262, 263, 487–491, 498
and use of Arabic language, 175–177
and use of English language, 177, 178
Shari'ah-compliant banks, 27, 44. *See also* Islamic banks; Islamic finance products
Shari'ah-compliant financial instruments, 44–46. *See also Sukuk*
Shari'ah-non-compliance risk, 8, 138–140, 154, 225, 237–257, 263, 264
Special purpose entities (SPEs), 146, 411–413
Special purpose vehicles (SPVs), 198, 201–203, 344, 349, 351, 354
Stable funding ratio, 22, 25, 26, 326. *See also* Long-term stable funding ratio; Net stable funding ratio (NSFR)
Standardised approach (SA or TSA), 15–19, 66, 137, 140, 288, 300–304, 307, 309, 310, 315
Statistical models, 313
Stock options, 408, 409
Stockbroking, 247, 388
Strategic risk, 294, 299
Stress testing, 16, 19, 29, 38–42, 136. *See also* Scenario analysis
Stress value at risk (stress VaR), 38. *See also* Stress testing
Sukuk
AAOIFI pronouncement on, 346
al-istithmar sukuk, 353, 355
asset-backed, 146, 349, 375, 376, 383, 385
asset-based, 146, 201, 349, 353, 375, 383
and banking environment, 44, 45
bankruptcy remoteness, 203, 204
and capital structure of Islamic banks, 100
collateral security structure, 205
contingent convertible, 100
conventional securities compared, 344, 345
convertibility option, 383
credit ratings, 146, 198, 201, 203, 330, 333, 499
effectively subordinated, 100
and growth of Islamic finance, 340, 361–363, 385
IILM issuance of, 330
ijarah sukuk, 349, 351
Islamic bonds, 198
istisna'a sukuk, 352–354
legal issues, 166, 198–209
legal risk, 226, 227
long-term liquidity funding, 334, 335
Malaysia, 358, 359, 362
market for, 339–342, 346–348, 361–363
market functions and market factors, 198–200
market risk and rate of return risk, 63
mudharabah, 352, 353, 390
murabahah, 355, 357, 358, 383, 421
musharakah, 248, 349, 352, 390
need for, 377
non-consolidation opinion, 203
online database and information, 484
operational risk, 146
overview, 339–342, 375
project financing, 347, 349, 376, 383
reasons for issuing, 342, 343
regulatory framework, 357–361
risk, 66
salam sukuk, 355–357, 383
secondary market, 340, 373
and securitisation, 146, 198–207, 342–346
securitisation structures, 349–357
separateness covenants, 203, 204
and short-term liquidity need, 269
true sale, 202, 248, 249
types of, 198
wakalah sukuk, 354, 356
Supervisory role for Islamic finance
and Basel Pillar 2, 20. *See also* Pillar 2
and global financial crisis, 264–271
group supervision, 270, 271
IFSB revised supervisory review process, 151
issues for supervisors, 267–271
overview, 8
Shari'ah supervisory boards, 172, 174–178, 181, 243–245, 262, 263
Systemic risk, 42, 81, 82, 290, 291, 296
Systemically important financial institutions (SIFI), 9, 133, 135, 265, 266

Taghrir (deception), 242
Tahawwut (Hedging) Master Agreement, 486
Tail risk, 29, 37, 38
Takaful (Islamic insurance), 7, 10, 86, 95, 96, 102–105, 253, 292, 378, 387, 388, 394, 418, 439, 475, 477, 482, 484
Takaful operator (TO), 103–105
Tawarruq, 90, 229, 327
Trade bills, 47, 48, 326, 328, 330
Trade finance assets, 327, 328
Trading book, 29, 38, 63, 64, 288, 333
Trading risk, 19, 239
Transparency, 44, 49, 51, 52, 54, 58, 71, 282, 300, 327, 329, 330, 332, 333, 411–413, 435, 452, 453, 456–470, 496, 497

TriBar Specialized Financing Report, 196–198
True sale, 146, 166, 181, 202, 208, 242, 248, 249, 344, 499

Unexpected loss (UL), 35, 37, 40, 58–62, 67, 69, 95, 102, 305–307, 313
Unit trust funds, 387, 391
Univariate models, 32, 33
'Uqud musammat (nominate contracts), 172. *See also* specific contracts

Validation of operational risk measurement model, 310, 314, 315
Value at risk (VaR), 35, 50, 51, 55, 58, 61, 62, 64, 67, 69–71
Virtuous cycle of transparency, 466–469, 497

Wakalah contracts, 99, 103, 149, 354, 356
Wakeel (agent), 99, 149
Wealth, protection of *(hifz al-mal)*, 238, 240, 257
World Bank, 267, 271